

Secondary-Default Remedies: Should Harshness Limit Enforcement?

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This Article examines a critical but largely unexplored issue in contract law: whether secondary defaults—that is, relatively minor or technical defaults not involving debt repayment—should justify enforcing severe contractual remedies. In the context of lending, this issue concerns whether those types of defaults should justify terminating financing commitments, accelerating the maturity of outstanding debt, and foreclosing on collateral, any of which can cause a firm’s failure. Although this issue arises constantly and its resolution can be critical to a firm’s survival, judges and lawyers lack clear answers. This Article analyzes and seeks to provide answers both under existing law and from a normative standpoint. It also investigates meaningful alternative secondary-default remedies—some that could be instituted by courts, others recommended to parties in contract design—that would not impose undue hardships on borrowers and third parties, including the public.

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INTRODUCTION

Financing is the lifeblood of most businesses.¹ Since the 1980s, corporate borrowing may have tripled.² Today, large firms often have billions of dollars of indebtedness³ which is governed by financing agreements that are variously called indentures, loan agreements, credit agreements, and similar terms (collectively, “financing agreements”).⁴ Unfortunately, the design of financing agreements has not kept up with this increasing reliance on debt. Boilerplate provisions that originally were intended to help investors and other lenders (collectively, “lenders”) monitor borrowers with limited debt now threaten the viability of even global businesses.

1. For international commerce, financing usually comes in the form of loans and letters of credit. Under a letter of credit or similar irrevocable guarantee, a bank is obligated (on behalf of a buyer) to pay a seller upon delivery of conforming goods. *See generally* Gao Xiang & Ross P. Buckley, *The Unique Jurisprudence of Letters of Credit: Its Origin and Sources*, 4 SAN DIEGO INT’L L.J. 91, 106 (2003) (outlining the history of letters of credit and negotiable instruments). *See also* Reid v. Key Bank of S. Me. Inc., 821 F.2d 9, 11 (1st Cir. 1987) (consisting of a dispute concerning the termination of a credit agreement); K.M.C. Co., v. Irving Tr. Co., 757 F.2d 752, 754 (6th Cir. 1985) (regarding an appeal from a judgment for breach of a financing agreement); Taggart & Taggart Seed, Inc. v. First Tenn. Bank Nat’l Ass’n, 684 F. Supp. 230, 232 (E.D. Ark. 1988), *aff’d*, 881 F.2d 1080 (8th Cir. 1989) (concerning multiple amendments made to a loan agreement post-default); First Nat’l Bank of Cicero v. Sylvester, 554 N.E.2d 1063, 1065–66 (Ill. App. Ct. 1990) (concerning an agreement for a line of operating credit); Creeger Brick & Bldg. Supply Inc. v. Mid-State Bank & Tr. Co., 560 A.2d 151, 152 (Pa. Super. Ct. 1989) (concerning an alleged failure to deal in good faith by failing to provide plaintiff with a line of credit).

2. *See* A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 FORDHAM L. REV. 963, 965 n.8 (1993) (quoting Stella Dawson, *Bankers Blame Credit Crunch on Weak Demand, Not Regulators*, Reuters, Oct. 7, 1991) (“The U.S. debt burden tripled in the 1980s as . . . corporations took on more debt [from leveraged buyouts and restructurings].”).

3. *Cf.* EDWARD I. ALTMAN, EDITH HOTCHKISS & WEI WANG, *CORPORATE FINANCIAL DISTRESS, RESTRUCTURING, AND BANKRUPTCY* 3 (John Wiley & Sons, Inc., 4th ed. 2019) (reporting that “[b]etween 1989 and 1991, 34 corporations with liabilities greater than \$1 billion filed for protection under Chapter 11 of the Bankruptcy Code; in the three-year period from 2001 to 2003, 102 of these ‘billion-dollar-babies’ with liabilities totaling \$580 billion filed for bankruptcy protection; and from 2008 to 2009, 74 such companies filed for bankruptcy with an unprecedented amount of liabilities totaling over \$1.2 trillion”).

4. The particular term sometimes depends on custom and practice. For example, financing agreements governing bank loans are usually called loan or credit agreements, whereas financing agreements governing a firm’s issuance of bonds or other long-term debt securities to a range of investors are often called indentures. The types of secondary-default provisions herein discussed are common to all such financing agreements. *See* Appendix 1.

In particular, most financing agreements define “Events of Default” as being triggered not only by serious defaults, such as a borrower’s failure to repay its debt, but also by relatively minor or technical defaults not involving debt repayment—in the language of this Article (using a term introduced by the Tenth Circuit),⁵ “secondary” defaults, as described below.⁶ Contractually, the occurrence of an Event of Default permits the lender to terminate any outstanding financing commitments,⁷ to accelerate the maturity dates⁸ of the outstanding indebtedness,⁹ and to exercise foreclosure remedies with respect to any collateral.¹⁰

Furthermore, an Event of Default in even a single financing agreement can trigger so-called “cross-default”¹¹ provisions in the borrower’s other financing agreements, enabling lenders on those other agreements to likewise terminate their financing commitments, accelerate payment of the indebtedness, and foreclose against collateral.¹² Most financing agreements also contain cross-acceleration clauses, enabling those remedies if the principal maturities of another financing agreement are accelerated.¹³ The result of a borrower’s financing commitments being terminated and the maturity of its debt being accelerated, whether or not coupled with foreclosures, often leads to the firm’s bankruptcy and possible

5. See *Greenberg v. Serv. Bus. Forms Indus., Inc.*, 882 F.2d 1538, 1542 (10th Cir. 1989) (observing that a loan-agreement default did not concern “a technical, secondary obligation such as payment of taxes” but rather violated the essential provisions regarding repayment of principal and interest) (emphasis added). References in this Article to “secondary” obligations likewise mean relatively minor or technical obligations not involving debt repayment.

6. See *infra* notes 18–22 and accompanying text (providing examples of secondary defaults).

7. For example, an Event of Default usually permits the lender to terminate the extension of any unused credit. Thus, a lender could terminate its obligation to advance \$100,000 in new loans, or to issue \$100,000 of new letters of credit, under a \$300,000 financing commitment of which \$200,000 is already being used.

8. This means that an Event of Default usually entitles the lender to require the borrower to immediately pay all outstanding principal maturities otherwise due in the future.

9. Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335, 359–60 (1991).

10. See PRAC. L. FIN., LENDER’S REMEDIES AND ENFORCEMENT ISSUES (Practice Note 8-500-5970) (discussing a lender’s available remedies under an event of default). Not all financing arrangements involve collateral; secured debt is more common among transactions involving individual borrowers, such as in the case of a home mortgage loan or auto loan. Sometimes an Event of Default might also permit a lender to demand additional collateral, such as collateralizing its letter-of-credit reimbursement obligation. See, e.g., *In re RadioShack Corp.*, No. 15-10197, 2015 Bankr. LEXIS 4541, at *385 (Bankr. D. Del. Mar. 12, 2015) (requiring the borrower put forth cash equal to 105% of the letter of credit amount to secure its reimbursement obligations); *In re Fairpoint Commc’ns, Inc.*, No. 09-16335, 2009 Bankr. LEXIS 5267, at *110–11 (Bankr. S.D.N.Y. 2009) (requiring a borrower to cash collateralize its reimbursement obligations).

11. See, e.g., *Bank One, Cleveland, N.A. v. Grantham, Inc.*, Nos. 90-G-1555, 90-G-1556, 1991 Ohio App. LEXIS 4722, at *2 (analyzing one such cross-default clause). A cross-default provision often requires a threshold amount that must have defaulted before it is triggered; for instance, if the parties negotiated a threshold amount of \$500,000, then a default under a \$250,000 financing agreement would not trigger a cross-default. See SYLVIE A. DURHAM, *DERIVATIVES DESKBOOK: CLOSE-OUT NETTING, RISK MITIGATION, LITIGATION* 2-11–2-13 (2d. ed. 2014).

12. DURHAM, *supra* note 11, at 2-12.

13. Jay M. Goffman & Suzanne D.T. Lovett, Recent Case Studies on Reinstatement: Charter Communication and Spectrum Brands, Panel Before the New York City Bankruptcy Conference (May, 24 2010).

liquidation.¹⁴ In reality, the termination of a borrower's financing commitments can, by itself, lead to the borrower's failure.¹⁵

A repayment default may well justify these severe consequences because repayment of the debt goes to the essence of a lending bargain.¹⁶ By definition, however, a secondary default would be relatively minor or technical and not involve debt repayment.¹⁷ Typical examples, which are set forth in detail in Appendix 1,¹⁸ include a borrower's delay in paying property taxes¹⁹ or in delivering audited financial statements²⁰; or a decline in the value of current assets;²¹ or the borrower's passing a board resolution merely authorizing, but not taking actual steps to initiate, its filing of a bankruptcy case.²² As next shown, however, many courts strictly enforce Events of Default arising from secondary defaults, favoring commercial certainty and freedom of contract over equitable principles.

In the seminal case of *Graf v. Hope Bldg. Corp.*,²³ for example, the New York Court of Appeals—the state's highest court—in a four-to-three decision strictly enforced

14. Without additional liquidity, the firm may well be unable to pay its accelerated debts. Its creditors therefore could enforce default remedies against the firm and its properties. To prevent those remedies becoming a "grab race," the author's experience is that borrowers normally file for bankruptcy, which automatically stays (that is, suspends) the exercise of those remedies. See 11 U.S.C. § 362(a).

15. See, e.g., *K.M.C. Co., v. Irving Tr. Co.*, 757 F.2d 752, 754 (6th Cir. 1985) ("K.M.C. contends that Irving's refusal without prior notice to advance the requested funds . . . ultimately resulted in the collapse of the company as a viable business entity."). In a recent case in which the author was a testifying expert, the termination of the company's financing commitments due to a secondary default would have caused its collapse. See First Expert Report of Steven L. Schwarcz Pursuant to Part 35 of the Civil Procedure Rules 1998, § 10(b), in *In the matter of CB&I UK Ltd.*, [2024] EWHC 398 (Ch) ("[The borrowing group's] inability to provide or renew letters of credit [the form of financing it utilized] would cause the collapse of [its] business.").

16. See, e.g., *David v. Sun Fed. Sav. & Loan Ass'n*, 461 So.2d 93, 96 (Fla. 1984) ("Failure to make timely payment is not a mere technical breach of covenant intended to preserve the security; it goes to the heart of the agreement between a mortgagor and mortgagee."); *Reed v. Lincoln*, 731 So.2d 104, 105 (Fla. Dist. Ct. App. 1999) ("[An acceleration clause] operates when there has been a default such as nonpayment of principal, interest, or failure to pay insurance premiums.").

17. See *supra* notes 5–10 and accompanying text. Admittedly, even a minor breach could have serious consequences if not cured. For example, the failure to pay taxes on property constituting collateral could cause the collateral's loss by tax sale, or the failure to pay insurance premiums could lead to a loss of coverage in the event collateral is destroyed by a fire or flood. As will be discussed, however, allowing time for the borrower to try to cure secondary defaults could mitigate their harshness. See *infra* Part IV.A.1.

18. See *infra* Appendix 1. Appendix 1 also shows that whether a breach should be classified as a secondary default may depend not only on the type of covenant but also on the nature, and thus consequences, of the breach.

19. See, e.g., *N. Star Apartments v. Goppert Bank & Tr. Co.*, 657 S.W.2d 253 (Mo. App. W.D. 1983) (holding that the defendant's nonpayment of property taxes by the technical due date amounted to an Event of Default despite the county tax collector allowing taxes to remain unpaid for two years before commencing a tax sale); *Carpenter v. Riley*, 675 P.2d 900 (Kan. 1984) (permitting acceleration after the defendant did not pay taxes due on certain property).

20. See, e.g., *Mercury Cos., v. Comerica Bank*, Civil Action No. 13-cv-01921, 2014 U.S. Dist. LEXIS 17736 (D. Colo. Feb. 12, 2014) (holding that a party's failure to timely provide audited financial statements constituted an Event of Default).

21. See, e.g., *In re Murray Energy Holdings Co.*, No. 19-56885, 2021 Bankr. LEXIS 2237, at *21 (Bankr. S.D. Ohio Aug. 13, 2021) (outlining a DIP Credit Agreement whereby the Debtors agreed to keep their Current Assets above a certain amount).

22. See, e.g., *In the matter of CB&I UK Ltd.*, [2024] EWHC 398 (Ch).

23. *Graf v. Hope Bldg. Corp.*, 171 N.E. 884 (N.Y. 1930).

foreclosure remedies notwithstanding a minor and unintended breach.²⁴ A firm's corporate secretary miscomputed the interest coming due on a loan and had the president, the only authorized corporate officer, sign a check for that incorrect amount (a shortfall of only \$401.87).²⁵ After the president left for a European trip, the secretary discovered the error and, when delivering the check, told the lender that the shortfall would be paid when the president returned.²⁶ Before the president returned, the lender accelerated the debt and commenced foreclosure.²⁷

Refusing to stay the acceleration and foreclosure, the court warned against affording equitable relief to a borrower absent inequitable conduct by the lender:²⁸ "[T]he court as a rule will not grant relief to the mortgagor from the effect of his default when nothing is done on the part of the mortgagee to render it unconscionable for him to avail himself of it."²⁹ Chief Judge Cardozo, joined by two other members of the court, dissented, favoring forgiving borrowers where "[T]he default is limited to a trifling balance, where the failure to pay the balance is the product of mistake, and where the mortgagee indicates by his conduct that he appreciates the mistake and has attempted by silence and inaction to turn it to his own advantage."³⁰ Judge O'Brien, writing for the majority, countered that "[w]e are not at liberty to revise while professing to construe" a contract.³¹

Although *Graf* involves a repayment default (albeit one that was unintended and minor), other courts have extended its holding to secondary defaults, which are unrelated to repayment.³² For example, numerous courts have cited *Graf* to uphold acceleration where a borrower failed to pay taxes on property that was not collateral.³³ At least one court has

24. See generally Bruce J. Bergman, *Strict Acceleration in New York Mortgage Foreclosure—Has the Doctrine Eroded?*, 8 PACE L. REV. 475 (1988) (evaluating the status of mortgage acceleration by reviewing the basics established in *Graf*).

25. *Graf*, 171 N.E. at 884.

26. *Id.*

27. The company then tendered payment of the shortfall amount, which the mortgagee rejected. *Id.* at 885.

28. Courts may well grant equitable relief to a borrower if the lender engages in inequitable conduct. Cf. *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979) (holding that the jury should have been instructed on whether the lender's exercise of a due-on-lease clause was based on an inequitable desire to take advantage of a technical default); *Bank of N.J. v. Brokers Fin. Corp.*, 557 F.2d 365 (3d Cir. 1977) (holding that a lender may not terminate its financing commitments under a five-year loan based on the impending expiration of a surety agreement which the lender negotiated to expire after merely one year); *Willcox v. Lloyds TSB Bank, PLC*, No. 13-00508, 2014 U.S. Dist. LEXIS 176706, at *33 (D. Haw. Dec. 23, 2014) (holding that borrowers plausibly alleged that lenders' increase in the variable interest rates of the loans breached the implied condition when it was done "for purposes of greed rather than for commercially reasonable reasons"); *MD3 Holdings, LLC v. Buerkle*, 159 A.D.3d 1483, 1484 (N.Y. App. Div. 4th Dep't. 2018) (concluding that a borrower is entitled to relief for a lender revoking a financing agreement based on information unavailable at the time of the initial commitment if the lender was acting in bad faith in its revocation); *Clayton v. Crossroads Equip. Co.*, 655 P.2d 1125, 1129 (Utah 1982) ("It would be highly inequitable to allow [the lender] to change its mind once it had accepted that contract . . . it is unfair to put the buyer in default based upon information which was apparently available . . . at the time [the lender] had accepted.").

29. *Graf*, 171 N.E. at 886.

30. *Id.* at 888.

31. *Id.* at 885.

32. See *supra* notes 5–10 and accompanying text.

33. See, e.g., *Jam. Sav. Bank v. Alley Spring Apartments Corp.*, N.Y.L.J., Apr. 2, 1980, at 13, col. 1 (Sup. Ct. Queens Cnty.); *Jam. Sav. Bank v. Avon Assocs.*, N.Y.L.J., Nov. 2, 1977, at 6, col. 3 (Sup. Ct. N.Y. Cnty.); *Fiedler v. Schefer*, 387 N.Y.S.2d 711, 711 (N.Y. App. Div. 2d Dep't 1976); *Jam. Sav. Bank v. Cohan*, 320 N.Y.S. 2d 471, 472 (N.Y. App. Div. 2d Dep't 1971); *Armstrong v. Rogdon Holding Corp.*, 247 N.Y.S. 682 (Sup. Ct.

upheld acceleration where a borrower failed to insure a mortgaged property.³⁴ Some courts have upheld acceleration for other secondary defaults, including breach of a covenant to keep a mortgaged property in good repair³⁵ and breach of an agreement to purchase petroleum products to be sold on a particular property.³⁶

The current state of the law on enforcement of remedies for secondary defaults is unsettled. When practicing law³⁷ and since then as a consulting expert to numerous major law firms,³⁸ the author has encountered continuing uncertainty among attorneys as to whether such defaults justify enforcing severe remedies that threaten a borrower's very existence.³⁹ No current scholarship provides clear guidance to attempt to resolve that uncertainty. This Article seeks to provide that guidance.

To that end, the Article proceeds in five parts. Part I examines the history of secondary-default provisions and remedies for breach. It also focuses on the purpose of including secondary-default provisions in financing agreements. Part II reviews the legal precedents on enforcing severe remedies for secondary defaults.⁴⁰ Part III conducts a normative analysis of secondary-default provisions and breach remedies, examining and applying the criteria—good faith, reasonableness, economic efficiency, and limiting material externalities—that generally govern enforcement of remedies.⁴¹ Part IV examines how to design less severe, but still meaningful, alternative remedies.

N.Y. Cnty. 1930). *But see* Karas v. Wasserman, 458 N.Y.S.2d 280, 281–82 (N.Y. App. Div. 3d Dep't 1982); Cent. Nat'l Bank of Canajoharie v. Paton, 439 N.Y.S.2d 619 (Sup. Ct. Oswego Cnty. 1981); King v. Giordano, N.Y.L.J., June 21, 1978, at 15, col. 6 (Sup. Ct. Kings Cnty.); Weber v. Berkowitz, N.Y.L.J., Dec. 11, 1970, at 20, col. 4 (Sup. Ct. Kings Cnty.); Brookman v. 12662 Realty Corp., N.Y.L.J., July 6, 1970, at 11, col. 44 (Sup. Ct. N.Y. Cnty.); Lincoln Sav. Bank v. Six Moffat Realty Co., N.Y.L.J., Mar. 25, 1970, at 15, col. 8 (Sup. Ct. Kings Cnty.); Clark-Robinson Corp. v. Jet Enter., 159 N.Y.S.2d 214 (Sup. Ct. Bronx Cnty. 1957); Norbant Realty Corp. v. A.C. Oaks, Inc., 116 N.Y.S.2d 215 (Sup. Ct. Westchester Cnty. 1952); Seaman's Bank for Sav. v. Wallenstein Realty Corp., 6 N.Y.S.2d 706 (Sup. Ct. Kings Cnty. 1938); York v. Hucko, 262 N.Y.S. 62 (Cnty. Ct. Madison Cnty. 1933); Germania Life Ins. Co. v. Potter, 109 N.Y.S. 435 (N.Y. App. Div. 1st Dep't 1908); Noyes v. Anderson, 26 N.E. 316 (N.Y. 1891).

34. Jordon v. Sharpe, 460 N.Y.S.2d 846 (N.Y. App. Div. 3d Dep't 1983), *appeal denied*, 59 N.Y.2d 968 (1983).

35. *See, e.g.,* Mills Land Corp. v. Halstead, 56 N.Y.S.2d 682 (Sup. Ct. Nassau Cnty. 1945).

36. *See In re Cumberland Garage, Inc.*, 73 N.Y.S.2d 571, 572–73 (Sup. Ct. Queens Cnty. 1947).

37. The author was a partner at Shearman & Sterling (now A&O Shearman) and also a partner and practice group chair at Kaye Scholer (now Arnold & Porter Kaye Scholer LLP, doing business as Arnold & Porter).

38. Since becoming a full-time academic, the author has served as a consulting expert to more than half of the world's top-50 law firms.

39. In the CB & I UK Ltd. February 2024 sanction hearing, for example, the author gave expert testimony to the English High Court of Justice on a controversy as to whether merely passing a board resolution to authorize, but not taking actual steps to initiate, the filing of a bankruptcy case should create an enforceable Event of Default under New York law. *See* First Expert Report of Steven L. Schwarcz, *supra* note 15.

40. Part II also includes a comparative-law analysis, contrasting United States and United Kingdom court decisions. *See infra* note 69 and accompany text. For example, this Article's recommendation to provide for default interest rather than automatically accelerating the indebtedness on the loan for a secondary default may be viewed as an unenforceable penal clause under English law. *See* Cavendish Square Holding BV v. Talal El Makdessi [2015] UKSC 67 (extending equitable relief to contractual provisions, including those that cause a disproportionate forfeiture).

41. Part III frames its analysis as one of contract enforcement—that is, enforcement of contractual remedies—not contract breach. As further explained, even though a contractual covenant breach may cause the secondary default, financing agreements already specify the applicable remedies (e.g., terminating outstanding financing commitments and accelerating and foreclosing on the debt). *See infra* notes 80–81 and accompanying

This Article's fifth Part is Appendix 1, which provides guidance for actually identifying secondary defaults. Although important for all financing agreements, clear identification would be especially important for public bond issues. Under the financing agreements (customarily called indentures) used in public bond issues, an indenture trustee, rather than investors who are the real parties in interest, sometimes has to make decisions about pursuing remedies.⁴² In making such a decision, the indenture trustee may have to exercise independent judgment and can be subject to being second-guessed and possibly sued if investors later disagree (or allege that they disagree as an *ex post* litigation strategy).⁴³ Furthermore, because the existence of an Event of Default raises the duty of an indenture trustee to a higher standard—that of a reasonably prudent person in like circumstances⁴⁴—the determination that a default constitutes an Event of Default could significantly increase the indenture trustee's duties. That determination therefore raises a possible conflict of interest: to avoid becoming subject to those increased duties, the indenture trustee may prefer that a default does not constitute an Event of Default. Appendix 1's guidance can help indenture trustees and investors, as well as judges and lawyers, make more objective determinations.⁴⁵

Before engaging in these inquiries, one might ask why parties do not voluntarily negotiate, post-default,⁴⁶ to fairly resolve the secondary-default problem. Professors Ayres and Gertner have observed, for example, that some provisions of contract law can function as penalty default rules to encourage parties to compromise to avoid unpalatable

text. That contractual specification of remedies should displace any contract-breach damages that otherwise would be applicable by default.

42. RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 144–45, 154–56 (3d ed. 2000). Indenture trustees administer indentures for virtually all issuers of bonds, both in the United States and abroad. The reason that indenture trustees, rather than investors, sometimes must make decisions about pursuing remedies is because the indirect holding system for securities can make it difficult to trace the chain of ownership of widely held and actively traded public bonds. *See, e.g.*, Thomas G. Ward & Daniel M. Dockery, *How the Indirect Holding System Affects Investor Suits*, LAW360 (Sept. 29, 2015), <https://www.law360.com/articles/706265/how-the-indirect-holding-system-affects-investor-suits> [<https://perma.cc/8FWK-DM2H>].

43. *See* Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037, 1040 (2008) (“Indenture trustees for defaulted bonds . . . face the conundrum that they are required to act prudently but lack clear guidance on what prudence means.”).

44. *See, e.g.*, Trust Indenture Act of 1939 § 315(c), 15 U.S.C. § 7700o(c) (2010) (“The indenture trustee shall exercise in case of default . . . the same degree of care and skill . . . as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”); RESTATEMENT (THIRD) OF TRUSTS § 77(1) (AM. L. INST. 2007) (“The trustee has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust.”).

45. Any normative analysis of whether, for purposes of triggering an indenture trustee's prudent-person duties, a default should constitute a secondary default or an Event of Default would of course be subject to existing law, which turns on how the indenture actually defines an Event of Default and how the Trust Indenture Act (Trust Indenture Act of 1939, codified as amended at 15 U.S.C. §§ 77aaa–77bbbb) specifies defaults that trigger such prudent-person duties.

46. The prevalence of Event-of-Default secondary-default remedies in financing agreements shows, empirically, that parties seldomly negotiate, pre-default, to resolve the secondary-default problem. *Cf. supra* notes 18–23 and accompanying text, illustrating those remedies. There could be various explanations for why they do not so negotiate: even sophisticated borrowers may not have consciously bargained to include secondary defaults in Events of Default, or they may have regarded that inclusion as boilerplate without fully recognizing its significance. *See infra* note 67 and accompanying text. Another possible explanation may be that borrowers do not expect to breach secondary obligations.

consequences.⁴⁷ In principle, setting a severe remedy for a secondary default could serve as a penalty default rule because neither the borrower nor its creditors should necessarily want a secondary default to cause the borrower's bankruptcy and possible liquidation.⁴⁸

In practice, though, there are at least two reasons why that penalty default rule may not lead to a fair compromise. First, the consequences of enforcing severe remedies for a secondary default—bankruptcy and possible liquidation—would likely be much worse for the borrower than for its creditors, who can (and normally do) diversify their lending.⁴⁹ Therefore, even if a borrower liquidates, the reduced (or in a worst case, non-) repayments to its creditors should not threaten their ongoing viability. The creditors, in other words, may well have extortionate, or at least much greater, negotiating power.⁵⁰

Another reason why that penalty default rule may not lead to a fair compromise is that a lender may actually want to use the secondary default as a justification to terminate its financing commitment. This could occur, for example, if the borrower's bankruptcy (caused by terminating financing) would be less onerous to the lender than putting significant additional money at risk.⁵¹

I. HISTORY OF SECONDARY DEFAULTS AND REMEDIES

Covenants imposing secondary obligations⁵² originally were included in financing agreements merely to provide an early indication of whether loan repayment might

47. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989) ("Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer.").

48. See *supra* notes 14–15 and accompanying text.

49. See, e.g., 12 C.F.R. § 32 (2025) (setting bank lending limits); *Lending Limits*, OFF. OF THE COMPTROLLER OF CURRENCY, <https://www.occ.treas.gov/topics/supervision-and-examination/credit/commercial-credit/lending-limits.html> [https://perma.cc/5S3C-U95R] ("Lending limits protect the safety and soundness of national banks, promote diversification of loans, and help ensure equitable access to banking services. These limits prevent excessive loans to one person, or loans to related persons who are financially dependent."). Lenders also customarily diversify their credit risk through syndication and sales of loan participations. See, e.g., *Loan Sales and Participations*, OFF. OF THE COMPTROLLER OF CURRENCY, <https://www.occ.treas.gov/topics/supervision-and-examination/credit/commercial-credit/loan-sales.html> [https://perma.cc/7ZZH-UQFW] (observing that banks "sell participations to diversify their loan portfolio . . .").

50. In October 2024, for example, the author was informed by a partner of a major law firm that a borrower-client of the firm recently was pressured into paying 1% of the total financing commitment as a fee—perhaps more accurately characterized as a "ransom"—to waive a minor secondary default that, by the terms of the financing agreement, could trigger an Event of Default.

51. This was the scenario in the CB&I UK Ltd. February 2024 sanction hearing. See *supra* notes 15, 22 & 39. As mentioned, the author gave expert testimony to the English High Court of Justice as to whether merely passing a board resolution to authorize, but not taking actual steps to initiate, the filing of a bankruptcy case should create an enforceable Event of Default. Lenders to the firm argued for that result, which would enable them to terminate commitments to extend additional letter-of-credit and guarantee financing. The firm contended that such termination of financing would destroy its business.

52. See *supra* note 6 (defining secondary obligations).

ultimately be at risk.⁵³ Their breach did not trigger Events of Default.⁵⁴ Rather, a breach typically permitted lenders to accrue interest at a stepped-up rate (“default interest”).⁵⁵ The payment of default interest was intended to compensate the lender for the increased risk.⁵⁶ Lenders and borrowers apparently both wanted to avoid acceleration and foreclosure.⁵⁷

Eventually, though, the redress for secondary defaults transformed from default interest to Event-of-Default remedies. The impetus for this transformation resembled a race to the bottom; as unsecured financing became more common, lenders wanted to protect their options in case a borrower defaulted. Including secondary defaults as Events of Default could advantage a lender by maximizing its potential remedies and negotiating power.⁵⁸ For example, if a secondary default created an Event of Default for Lender A but enabled Lender B only to charge default interest, Lender A could not only ask for higher interest but also could bargain for collateral in return for waiving the default, thereby giving it a repayment priority over Lender B.⁵⁹

II. REVIEW OF THE ENFORCEMENT JURISPRUDENCE

The legal precedents on enforcing severe remedies for secondary defaults are limited. The majority of decisions enforce Event-of-Default remedies for breach, including

53. See COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 1965—MODEL DEBENTURE INDENTURE PROVISIONS ALL REGISTERED ISSUES 1967 AND CERTAIN NEGOTIABLE PROVISIONS WHICH MAY BE INCLUDED IN A PARTICULAR INCORPORATING INDENTURE 207 (1971) (outlining the notice of default). Cf. Daniel Schwarcz, Univ. of Minn., Am. L. Inst.’s 94th Ann. Meeting, Speech Accepting the ALI Early Career Scholar Award: The Failures of State Insurance Regulation (May 24, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2974099 (observing that, “[i]ronically, states’ failure to seriously address insurance discrimination against socially disadvantaged groups has also allowed criticisms against legitimate forms of insurance discrimination to persist” and explaining that “insurers’ use of credit information in rating and underwriting auto and homeowners insurance” does not harm minority and low income communities but, instead, provides a “predictive effect of credit information for assessing auto and home risk [that] is unrelated to policyholder income or race”).

54. Cf. *Murphy v. Fox*, 278 P.2d 820, 825 (Okla. 1955) (reviewing early examples of secondary defaults and their remedies).

55. See, e.g., *In re 1141 Realty Owner LLC*, No. 18-12341, 2020 Bankr. LEXIS 710, at *7 (Bankr. S.D.N.Y. Mar. 17, 2020) (noting that the borrower’s non-monetary default, specifically the failure to maintain a valid liquor license, constitutes a default that warrants the payment of default interest).

56. See, e.g., *Anderson v. Hancock*, 820 F.3d 670, 676 (4th Cir. 2016) (emphasizing that default interest can compensate lenders for increased risk, in lieu of immediately foreclosing); *In re 1111 Myrtle Ave. Grp., LLC*, 598 B.R. 729, 741 (Bankr. S.D.N.Y. 2019) (noting that courts view a higher default interest rate as a way of compensating for increased risk); *In re Kimbrell Realty/Jeth Ct., LLC v. Fed. Nat’l Mortg. Ass’n*, 483 B.R. 679, 689 (Bankr. C.D. Ill. 2012) (acknowledging that a 4% increase in the default interest rate is reasonable to compensate the lender for the increased risk on a delinquent loan).

57. Cf. *III. Breaches Under Specific Oil and Gas Contracts*, in TXCLE ADVANCED OIL, GAS & ENERGY RES. L., (explaining the desire to avoid foreclosure that would subject lenders to take over risky business operations); COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 1965—MODEL DEBENTURE INDENTURE PROVISIONS ALL REGISTERED ISSUES 1967 AND CERTAIN NEGOTIABLE PROVISIONS WHICH MAY BE INCLUDED IN A PARTICULAR INCORPORATING INDENTURE, *supra* note 53, at 209 (same).

58. See Ray Garret, Jr., *A Borrower’s View of the Model Corporate Debenture Indenture Provisions*, 21 BUS. LAW. 675, 677–78 (1966) (explaining the rights conferred by indenture and contracting).

59. Cf. *id.* at 680 (discussing the concern of unsecured lenders that no other lender be given higher repayment priority). This race to the bottom was part of a process that eventually has resulted in extremely lengthy and complex financing agreements. See Henry S. Drinker, Jr., *Concerning Modern Corporate Mortgages*, 74 U. PA. L. REV. 360, 363 (1926). Whether the borrower would be prepared to collateralize Lender A’s loan and/or pay higher interest would, of course, be fact dependent.

terminating financing commitments, accelerating debt, and foreclosing.⁶⁰ Judges especially became sympathetic to lenders during the 1950s–60s, a period marked by recessions and inflation.⁶¹ This sympathy has continued, with some courts observing that banks are not charities, and thus are not expected to throw good money after bad to benefit a borrower.⁶² Rather, lenders assess risk *ex ante* and assume that courts will not alter the risk allocation *ex post*.⁶³ Inferring a duty to lenders of “kindness” or “good cause” to change the allocation could breed costly litigation.⁶⁴

The minority of courts, perhaps empathizing with Judge Cardozo’s intuition,⁶⁵ have refused to enforce severe remedies for secondary defaults.⁶⁶ Some reason that even sophisticated borrowers, which should understand the implications of unambiguous contractual terms, may not have consciously bargained to include secondary defaults as Events of Default or may have regarded that inclusion as boilerplate without fully recognizing its significance.⁶⁷ Financing agreements that are laden with boilerplate terms can be suspect because “[a] party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms.”⁶⁸

60. See *supra* notes 23–37 and accompanying text.

61. William C. Brainard & George L. Perry, *Making Policy in a Changing World*, in ECONOMIC EVENTS, IDEAS, AND POLICIES: THE 1960S AND AFTER 43, 61 (2000).

62. See, e.g., *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1358 (7th Cir. 1990) (“[The bank] need not throw good money after bad.”).

63. *Id.*

64. *Id.* at 1357. See also *Mkt. St. Assocs. Ltd. P’ship v. Frey*, 941 F.2d 588, 594 (7th Cir. 1991) (“[E]ven after you have signed a contract, you are not obliged to become an altruist toward the other party and relax the terms if he gets into trouble in performing his side of the bargain.”). Cf. *Overby*, *supra* note 2, at 966 (finding that courts generally favored strict enforcement for lenders over relief for borrowers by a ratio of almost three to one).

65. Cf. *supra* note 30 and accompanying text (discussing Judge Cardozo’s dissent in the *Graf* case).

66. See, e.g., *Norbant Realty Corp. v. A.C. Oaks, Inc.*, 116 N.Y.S.2d 215, 216 (Sup. Ct. Westchester Cnty. 1952) (“[F]oreclosure should not be decreed for a mere technical default.”); *Domus Realty Corp. v. 3440 Realty Co.*, 40 N.Y.S.2d 69, 73 (Sup. Ct. N.Y. Cnty. 1943) (“[T]his trivial default is entirely out of proportion to the harshness of the plaintiff’s action in declaring the entire amount of the principal due under the acceleration clause.”), *aff’d*, 41 N.Y.S.2d 940 (App. Div. 1943); *Trowbridge v. Malex Realty Corp.*, 191 N.Y.S. 97, 101 (App. Div. 1st Dep’t 1921) (“As to the power of a court of equity to relieve a mortgagor from a mere technical default in payment where such default is not willful, there can be no doubt.”); *Germania Life Ins. Co. v. Potter*, 109 N.Y.S. 435, 436 (App. Div. 1st Dep’t 1908) (“A court of equity will not entertain an action to foreclose a mortgage because of technical default in the payment of taxes.”); *Graf v. Hope Bldg. Corp.*, 171 N.E. 884, 888 (N.Y. 1930) (Cardozo, J., dissenting) (“It may be unconscionable to insist upon adherence to the letter where the default is limited to a trifling balance, where the failure to pay the balance is the product of mistake, and where the mortgagee indicates by his conduct that he appreciates the mistake and has attempted by silence and inaction to turn it to his own advantage.”).

67. Cf. *In re Lehman Bros. Holdings Inc.*, 541 B.R. 551, 572 (Bankr. S.D.N.Y. 2015) (showing that there have been cases where parties, although sophisticated, omitted discussing the period of negotiation entirely); see also *Garret*, *supra* note 58, at 679 (comparing those provisions in which specific negotiation is necessary with those that have effectively become standard, such as “covenants to pay the principal and interest, to pay taxes, to maintain the properties, and to maintain corporate existence”).

68. RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b (AM. L. INST. 1981). This Article deals with business-related financing agreements. Courts are even more likely to refuse to enforce boilerplate terms to which consumers do not meaningfully consent. See, e.g., Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1464 n.14 (1989) (citing KARL LLEWELLYN, *THE COMMON LAW TRADITION* 370 (1960)) (explaining that the “typical consumer buying insurance has not assented to the myriad of essentially invisible boilerplate terms in an adhesion contract Customers submit to these terms [in standard form insurance policies] knowing that they are not and cannot be fully aware of them.”); Mark C. Rahdert, *Reasonable*

Other courts have refused to enforce severe remedies for secondary defaults based on a “no harm, no foul” approach: that the absence of significant damage justifies non-enforcement.⁶⁹ This can be exemplified by the occurrence of a secondary default towards the end of a long-term loan where the lender already has received significant repayment and earned its bargained-for rate of return, and the secondary default does not clearly threaten the remaining repayment.⁷⁰ Still other courts, following the Restatement of Contracts, have reformed secondary-default provisions to avoid a disproportionate forfeiture,⁷¹ such as causing the firm’s bankruptcy.⁷² Their reasoning at least implicitly recognizes that the forfeiture could impose significant harm on innocent third parties. For example, a major corporation failing due to a relatively minor breach could impact not just shareholders and creditors but its employees and the communities in which they live.⁷³ This type of third-party-harm reasoning is foundational to the jurisprudence on limiting freedom of contract.⁷⁴

III. NORMATIVE ANALYSIS: CRITERIA THAT SHOULD GOVERN THE ENFORCEMENT OF SECONDARY-DEFAULT REMEDIES

Including secondary-default provisions in financing agreements has a legitimate business purpose: to provide an early indication of whether loan repayment might ultimately be at risk.⁷⁵ The normative question is whether a breach of those provisions should justify enforcement of severe remedies that threaten a firm’s existence and potentially impact the public. This Part examines what criteria should govern the enforcement of secondary-default remedies.

Expectations Reconsidered, 18 CONN. L. REV. 323, 373 (1986); William Mark Lashner, *A Common Law Alternative to the Doctrine of Reasonable Expectations in the Construction of Insurance Contracts*, 57 N.Y.U. L. REV. 1175, 1176 (1982). But cf. K. N. Llewellyn, *The Standardization of Commercial Contracts in English and Continental Law*, 52 HARV. L. REV. 700, 704 (1939) (advocating for the presumptive enforcement of boilerplate terms because those terms represent an expert’s view on what the contract ought to provide).

69. Because the legal precedents on enforcing severe remedies for secondary defaults are limited, it may be instructive to compare U.K. court decisions on remedies for secondary defaults. Under English law, courts use the property law doctrine of Relief of Forfeiture as a basis to provide equity. Michael V. Kokkinofas, *Relief of Forfeiture: Equity’s Anomalous Intervention Following an Event of Default*, 5 U. COLL. LONDON. J.L. & JURIS. 266, 267 (2016). Under the original doctrine, if a Relief of Forfeiture is granted, a tenant is allowed to return and re-occupy premises re-entered by a landlord. *Id.* at 274. There is no option under English law for a borrower to rely on equity to intervene in prior negotiated financing agreements. *Id.* at 269. Nonetheless, through an analogy to property law, the courts appear to apply the Relief of Forfeiture doctrine to financing agreements, especially if property is used as collateral. *Id.* at 278–79.

70. See, e.g., *Noyes v. Anderson*, 26 N.E. 316, 317 (N.Y. 2d Div. 1891) (declining foreclosure after the lender received the benefit of its bargain and a late minor default that was promptly cured which posed no real risk to the lender).

71. See RESTATEMENT (SECOND) OF CONTRACTS § 229 (AM. L. INST. 1979) (“To the extent that the non-occurrence of a condition would cause disproportionate forfeiture, a court may excuse the non-occurrence of that condition unless its occurrence was a material part of the agreed exchange.”).

72. See *supra* note 14 and accompanying text.

73. See, e.g., *In re Prime Motor Inns*, 131 B.R. 233, 236 (Bankr. S.D. Fla. 1991) (permitting an injunction to prohibit the lender from accelerating a loan after a technical default for the delay in delivering audited financial statements because such acceleration would cause irreparable harm to the borrowers and would also impact the public interest).

74. See *infra* notes 108–13 and accompanying text.

75. See *supra* note 53 and accompanying text.

Traditionally, three criteria have played critical roles in analyzing contractual enforceability: good faith,⁷⁶ reasonableness,⁷⁷ and economic efficiency.⁷⁸ Parts III.A, III.B, and III.C next explain these criteria and how they should apply to enforcing remedies for secondary defaults. Thereafter, Part III.D explains why material third-party harm, or “externalities,” should also limit freedom of contract and how that limitation should apply to enforcing secondary-default remedies.

A threshold question is why this Article frames its analysis as one of contract enforcement, as opposed to contract breach. After all, the Article is concerned with secondary defaults resulting from the breach of covenants in financing agreements.⁷⁹ The answer is that the Article focuses not on the breach but, rather, on the severe remedies that the breach triggers.⁸⁰ By agreeing to Event-of-Default remedies as the covenant-breach (and thus secondary-default) remedies, the contracting parties displace the need to apply standard contract-breach damages, which are based on restitution and expectation.⁸¹

A. Good Faith

Good faith is central to analyzing contractual enforceability. The Restatement of Contracts imposes an obligation of good faith in every contract’s enforcement: “Every contract imposes upon each party a duty of good faith and fair dealing in its performance *and its enforcement*.”⁸² The Uniform Commercial Code (UCC) similarly imposes an obligation of good faith in the enforcement of commercial contracts: “Every contract or duty within the [UCC] imposes an obligation of good faith in its performance *and enforcement*.”⁸³

Outside of a specific context, however, the meaning of good faith can be vague. The Restatement, for example, states that “[g]ood faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the

76. See, e.g., Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1471 n.94 (1980) (citing *Morello v. Levakis*, 293 Mass. 450, 200 N.E. 271 (1936)) (courts are more likely to find that a breaching party has substantially performed (thereby mitigating damages for their breach) where the breach entails “intentional but good-faith deviations from the contract specifications”); see also *Holt v. Sims*, 94 Minn. 157, 160 (Minn. 1905); *Cassinelli v. Stacy*, 238 Ky. 827, 838 (Ky. Ct. App. 1931).

77. Cf. Farber, *supra* note 76, at 1476 (advocating “deliberate overcompensation of plaintiffs” where “the breaching party may have failed to meet the standards of commercial reasonableness prevalent among honest business people”). There has long been an attempt to make commercial law more responsive to and reflective of commercial reality. See, e.g., Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1769 (1996); Steven L. Schwarcz, *Rethinking Commercial Law’s Uncertain Boundaries*, 14 HARV. BUS. L. REV. 234, 243 (2024).

78. See generally Farber, *supra* note 76 (contemplating the debate surrounding economic efficiency of contractual breaches as highlighted by leading breach cases).

79. See, e.g., *supra* notes 37–39 and accompanying text.

80. See *supra* notes 7–10 and accompanying text.

81. See, e.g., Randolph Sloof, Hessel Oosterbeek & Joep Sonnemans, *On the Importance of Default Breach Remedies*, 163 J. INSTITUTIONAL & THEORETICAL ECON. 5, 13 (2007) (noting that because it takes the consent of both parties to agree upon remedies resulting from default, the parties are more likely to stick with them than expectation or reliance damages). This Article later references restitution and expectation damages in assessing possible alternative remedies. See *infra* Part IV.

82. RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. L. INST. 1981) (emphasis added).

83. U.C.C. § 1-304 (AM. L. INST. & UNIF. COMM’N 2022) (emphasis added).

justified expectations of the other party.”⁸⁴ That purpose and those expectations are unclear absent a context. This Article later examines what good faith should mean in the specific context of enforcing severe remedies for a secondary default.⁸⁵

B. Reasonableness

At least in a commercial context, the enforcement of remedies is subject to a reasonableness standard. UCC § 9-610, which generally governs enforcement against collateral, requires that “[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable.”⁸⁶ Likewise, UCC § 9-607, which governs enforcement against intangibles such as rights to payment, requires that a “secured party shall proceed in a commercially reasonable manner”⁸⁷

Outside of a specific context, the meaning of reasonableness—just like the meaning of good faith—can be vague.⁸⁸ Scholars have even argued, channeling Gertrude Stein, that the UCC’s various references to reasonableness as a standard have no “‘there’ there,”⁸⁹ suggesting it is a meaningless standard.⁹⁰ To the contrary, though, courts look to expert testimony to determine what reasonableness should mean in a given context.⁹¹ This Article later examines what reasonableness should mean in the specific context of enforcing severe remedies for a secondary default.⁹²

Interestingly, the concept of reasonableness appears to be inextricably tied to good faith. For example, the UCC defines good faith as “honesty in fact and the observance of

84. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (AM. L. INST. 1981).

85. See *infra* Part IV.

86. U.C.C. § 9-610(b) (AM. L. INST. & UNIF. COMM’N 2022).

87. U.C.C. § 9-607(c) (AM. L. INST. & UNIF. COMM’N 2022).

88. Cf. Jay M. Feinman, *Good Faith and Reasonable Expectations*, 67 ARK. L. REV. 525, 535 (2014) (observing that “[r]easonableness is contextual because it depends on ‘customs and mores,’ and customs and mores vary depending on time, place, setting, background, and experiences of contracting parties”).

89. See ALAN SCHWARTZ & ROBERT SCOTT, *COMMERCIAL TRANSACTIONS, PRINCIPLES AND POLICIES* 18 (2d ed. 1991) (arguing that “the question whether a particular business practice reflects ‘the observance of reasonable commercial standards of fair dealing in the trade’ cannot be answered by the existence of the practice itself. The evaluator must have some moral criteria, derived independently of the practice, by which to decide what practices are ‘reasonable’ and ‘fair’”).

90. Stein’s famous phrase “There is no there there.” comes from her book. See GERTRUDE STEIN, *EVERYBODY’S AUTOBIOGRAPHY* 289 (1937). Although that phrase is often interpreted as a slight, it apparently means simply that her family’s house had been torn down to make way for an office park. See, e.g., Ben Zimmer, *Why Gertrude Stein’s ‘No There There’ Is Everywhere*, WALL ST. J. (Feb. 2, 2018), <https://archive.ph/791U1> [<https://perma.cc/2835-GJRC>].

91. See, e.g., *In re Exxon Mobil Corp.*, 389 S.W.3d 577, 580–81 (Tex. App. 2012) (observing that questions regarding reasonableness, in this case the reasonableness of a settlement, are often guided by expert testimony); *Chomat v. N. Ins. Co. of N.Y.*, 919 So.2d 535, 538 (Fla. Dist. Ct. App. 2006) (same); *Ex parte Dow Corning Ala., Inc.*, 297 So.3d 373, 378 (Ala. 2019) (reaffirming that expert testimony is often used to establish reasonableness). The author has served as an expert witness to explain commercial reasonableness to the court in various litigations, including the several lawsuits against Enron’s law firm Vinson & Elkins LLP. Cf. Steven L. Schwarcz, *Judge Jed Rakoff: Personal Impressions of a Testifying Expert Witness (and Anatomy of a UCC Foreclosure)*, 80 NYU ANN. SURV. AM. L. 21 (2023) (discussing the author’s expert-witness testimony in *Patriarch Partners XV, LLC v. U.S. Bank Nat’l Ass’n*, No. 16 Civ. 7128, 2017 WL 3822603 (S.D.N.Y. Aug. 28, 2017) (on the issue of whether a proposed auction foreclosure sale of certain financial assets would be reasonable as a matter of commercial custom and practice)).

92. See *infra* Part IV.

reasonable commercial standards of fair dealing.”⁹³ Professor Farnsworth explains that good faith enforcement involves an inquiry about reasonableness.⁹⁴ Professor Feinman further elucidates that “[g]ood faith is simply another embodiment of the basic principle of contract law—the protection of reasonable expectations.”⁹⁵

From these perspectives, reasonableness is the fundamental criterion which good faith seeks to protect: “The obligation of good faith . . . emanates from the protection of reasonable expectations, which is the basic principle of contract law.”⁹⁶

C. Economic Efficiency

Economists tend to equate net value creation with efficiency.⁹⁷ There are two measures of efficiency: Pareto and Kaldor-Hicks.⁹⁸ Something is Kaldor-Hicks efficient if it creates net value regardless of who wins and who loses.⁹⁹ In contrast, something is Pareto efficient if it makes at least one party better off without making any other parties worse off.¹⁰⁰ In practice, Kaldor-Hicks efficiency “improves upon Pareto efficiency through a slightly less restrictive approach which is widely endorsed by economists.”¹⁰¹ Accordingly, Kaldor-Hicks should be the measure of economic efficiency applied to assess the enforcement of secondary-default remedies.

Voluntarily agreed contracts—even those in which secondary defaults trigger Events of Default—should be Kaldor-Hicks efficient, at least as between the contracting parties.¹⁰² For a contract that could cause externalities, however, the efficiency assessment

93. U.C.C. § 1-201(b)(20) (AM. L. INST. & UNIF. L. COMM’N. 2024) (emphasis added).

94. E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 668 (1963); cf. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (AM. L. INST. 1981) (explaining that good faith performance or enforcement of a contract excludes conduct which violates community standards of decency, fairness, or reasonableness).

95. Feinman, *supra* note 88, at 526.

96. *Id.* at 569. But cf. Robert S. Summers, ‘Good Faith’ in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 209 (1968) (observing that the ABA Committee on the Proposed Commercial Code had expressed concern about including the term “reasonable commercial standards” in new revisions of the UCC because that term might invoke usages, customs, or practices perhaps existing at a particular time).

97. See, e.g., Marvin B. Lieberman & Natarajan Balasubramanian, *Measuring Value Creation and Its Distribution Among Stakeholders of the Firm* (June 20, 2007), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2382099 (noting that value creation by a firm is equivalent to improving a firm’s efficient use of resources).

98. Matthew D. Adler, *Cost-Benefit Analysis*, in *ENCYCLOPEDIA OF LAW & SOCIETY: AMERICAN AND GLOBAL PERSPECTIVES* 305–07 (David S. Clark ed., 2007).

99. For an overview of these theories see J. R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939); J. R. Hicks, *The Valuation of the Social Income*, 7 ECONOMICA 105 (1940).

100. ROBIN PAUL MALLOY, *LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING* 189–90 (2004).

101. Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243, 247 (2009).

102. Cf. MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* 7 (1993) (observing that “if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it”).

should take significant third-party harm into account.¹⁰³ Thus, a financing agreement setting severe remedies for secondary defaults, which could cause the borrower's bankruptcy,¹⁰⁴ might not be Kaldor-Hicks efficient if the resulting third-party harm is likely to exceed the net benefit to the contracting parties.

Finally, it should be noted that secondary-default provisions may be unnecessary if all default risks could be accurately accounted for in pricing.¹⁰⁵ Resolving inaccuracy in pricing models would be a more efficient alternative to courts needing to weigh these provisions in the first place. As later discussed, however, pricing could not completely obviate the need to include secondary-default provisions in financing agreements.¹⁰⁶

D. Material Externalities

The creation of material externalities could limit freedom of contract. Although freedom of contract typically is believed to produce beneficial societal outcomes, scholars argue that it should not be absolute. Rather, it should be subject to constraints based on public policy, paternalism, and externalities.¹⁰⁷ These limitations arose, in part, because absolute contractual freedom “began to offend the sense of justice”¹⁰⁸

Constraints based on paternalism and public policy are unlikely to apply in this Article's context of corporate borrowing. The constraints based on externalities might apply. There is, however, a “major conceptual” problem of “[d]etermining . . . which [externalities] . . . are to count in constraining the ability of parties to contract with each other.”¹⁰⁹ Realistically, the law cannot control all externalities, even those that are material.¹¹⁰

Nonetheless, contractual freedom should be constrained to avoid causing significant harm to members of the public, who cannot contract to protect themselves,¹¹¹ especially if

103. See, e.g., NATHANIEL HENDREN, REDISTRIBUTIVE CONCERNS: KALDOR HICKS AND THE INVERSE OPTIMUM 21 (2023), https://economics.mit.edu/sites/default/files/inline-files/lecture_2_-_redistributive_concerns.pdf [<https://perma.cc/ZL59-YK4X>] (observing that in determining Kaldor-Hicks efficiency, “externalities would need to be accounted for”).

104. Cf. *supra* note 14 and accompanying text (observing that the result of a borrower's financing commitments being terminated and the maturity of its debt being accelerated would inexorably lead to bankruptcy).

105. Claudio Borio & Philip Lowe, *To Provision or Not to Provision*, 2001 BIS Q. REV. 36, 46.

106. See *infra* notes 202–03 and accompanying text.

107. Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 520–21, 535–39 (1999).

108. LEE BOLDEMAN, THE CULT OF THE MARKET: ECONOMIC FUNDAMENTALISM AND ITS DISCONTENTS 252 (2007). Cf. 16A C.J.S. CONST. LAW § 824 (2025) (observing that contractual freedom should be “limited, restrained, and circumscribed” to protect important public interests).

109. TREBILCOCK, *supra* note 102, at 20 and accompanying text.

110. Cf. *id.* at 58 (explaining that if externalities resulting from everyday transactions justified prohibiting the exchange process or putting constraints upon it, then “freedom of contract would largely be at an end”); *id.* at 59–61 (explaining that different value judgments have different implications for resolving the externalities problem); R.H. COASE, THE FIRM, THE MARKET, AND THE LAW 24 (1988) (arguing that the existence of externalities does not establish a prima facie case for intervention because government regulation is also not without cost).

111. Cf. Henry N. Butler & Jonathan R. Macey, *Externalities and the Matching Principle: The Case for Reallocating Environmental Regulatory Authority*, 14 YALE L. & POL'Y REV. 23, 29 (1996) (leaving open the possibility that government intervention might be justified to prevent externalities that cannot be internalized through Coasian bargaining).

the parties can find meaningful lower cost alternative remedies.¹¹² Applying this formulation to enforcing contractual remedies for secondary defaults suggests that such remedies should not include severe Event-of-Default remedies such as terminating financing commitments, accelerating debt, or foreclosure. As observed, those remedies are likely to force a borrower into bankruptcy.¹¹³ The bankruptcy of a firm would not only impact its shareholders and creditors; it also could impact members of the public, including the firm's employees and the communities in which they live.¹¹⁴ Furthermore, if the firm is systemically important, its bankruptcy could spark a systemically harmful financial collapse,¹¹⁵ with widespread social and economic damage.¹¹⁶

Removing severe Event-of-Default remedies for secondary defaults would require contracting parties to design meaningful alternative remedies. Part IV next engages design.

IV. DESIGNING ALTERNATIVE REMEDIES

This Part seeks to design meaningful alternative secondary-default remedies that would not impose undue hardships on borrowers and third parties, including the public. Some of those remedies would be instituted by courts, others are recommendations to parties in contract design. Part IV.A examines and assesses, from the standpoint of Part III's criteria, possible remedies inspired by past responses. Part IV.B examines and similarly assesses possible remedies based on observations from the high-yield debt market. Part IV.C summarizes the Article's recommendations. Finally, Part IV.D examines whether lenders could price their loans to obviate the need to include secondary-default provisions, thereby avoiding the need to assign remedies.

A. Remedies Inspired by Past Responses

Past responses concerning secondary defaults suggest at least three possible non-Event-of-Default—that is, less severe—remedies for secondary defaults: Conditioning severe secondary-default remedies on notice and reasonable grace periods; charging default interest; or requiring parties in good faith, after default, to try to negotiate reasonable alternative remedies.

112. Cf. *id.* at 29–30 (arguing, in the environmental context, that government regulation may be appropriate to require a polluter to bear the full costs of its activities when the externality is significant and cannot be bargained away, and the benefits of the regulation outweigh the costs); Steven L. Schwarcz, *The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability*, 90 NOTRE DAME L. REV. 1, 21 (2014) (arguing that regulation should limit systemically risky externalities that could cause third parties to be injured).

113. See *supra* note 14 and accompanying text.

114. Cf. *supra* note 73 and accompanying text (describing the consequences of a major corporation failing).

115. See, e.g., Mathieu Bédard, *Are Dominos a Good Metaphor for Systemic Risk in Banking?*, 17 INT'L J. BUS. 352, 353 (2012) (comparing financial contagion theories of systemic risk in banking and arguing that the failure of a systemically important firm could spark a systemic collapse by prompting investors to question the solidity of similar firms).

116. Cf. Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Rsrv. Sys., Remarks at the Association of American Law Schools Midyear Meeting: Corporate Governance and Prudential Regulation (June 9, 2014), <https://www.federalreserve.gov/newsevents/speech/tarullo20140609a.htm> [<https://perma.cc/2TEW-E5LD>] (observing that risk-taking by systemically important firms “carries substantial potential societal consequences”).

1. *Conditioning Severe Secondary-Default Remedies on Notice and Reasonable Grace Periods*

A crucial reason that imposing severe remedies for a secondary default can cause undue hardships is that being relatively minor or technical, the default may not be the focus of a borrower's attention; hence the borrower may lack an opportunity to try to cure the default, thereby avoiding enforcement of those remedies. Although some secondary-default provisions contractually resolve this quandary by requiring lenders to give notice and a grace period to borrowers before the provision's breach becomes an Event of Default,¹¹⁷ many do not¹¹⁸ and some are ambiguous. Moreover, even where secondary-default provisions require notice and a grace period for accelerating debt, they may well lack that requirement for terminating financing commitments.¹¹⁹ Notice and a reasonable grace period would enable the borrower to try to avoid enforcement by curing the default.

Absent that contractual protection, some courts have relied on the obligation of good faith to infer a notice-and-grace-period, and to require the lender's compliance therewith, before enforcing severe remedies for breach. In *K.M.C. Co. v. Irving Tr. Co.*,¹²⁰ for example, the Sixth Circuit held that a lender had an implied good faith obligation to give reasonable notice to its borrower before cutting off funding under a line of credit, to enable the borrower to try to line up alternative financing: "this obligation to act in good faith would require [lender to give] a period of notice to [borrower] K.M.C. to allow it a reasonable opportunity to seek alternate financing, absent valid business reasons precluding [lender] from doing so."¹²¹ Similarly, in *Reyes v. Wells Fargo Bank, N.A.*,¹²² the court

117. See, e.g., Lloyd, *supra* note 9, at 359–60.

118. For instance, Clause 23 of the model Multicurrency Term and Revolving Facilities [Loan] Agreement published by the Loan Market Association (LMA), an organization focused on "establishing sound, widely accepted market practice . . . to promote the syndicated loan as one of the key debt products available to borrowers across the [European, the Middle Eastern, and African]," lists "recommended" Events of Default. Press Release, Loan Mkt. Ass'n, Loan Market Association and European Leveraged Finance Association Publish Best Practice Guide to Sustainability Linked Leveraged Loans, (July 28, 2021), <https://www.lma.eu.com/news-publications/press-releases?id=191> [<https://perma.cc/78CP-UHUD>]. Clause 23.2 references financial covenants, any breach of which would automatically constitute an Event of Default (without the requirement of notice or a grace period). Clause 23.3(a) provides that any other non-repayment breach of a financing agreement would automatically constitute an Event of Default unless, per clause 23.3(b), the parties specifically require a notice-and-grace period. Cf. Sue Wright, *Representations, Undertakings and Events of Default*, in THE HANDBOOK OF INT'L LOAN DOCUMENTATION 224 (2d. ed. 2014) (observing that the breach of any undertaking in a financing agreement may automatically constitute an Event of Default unless the agreement requires a notice-and-grace period; and that a notice-and-grace period would not be typical, for example, for repayment and financial-covenant undertakings or for undertakings to maintain insurance or for undertakings the breach of which themselves have a grace period but no prior required notice); Ningzhong Li, Yun Lou & Florin P. Vasvari, *Default Clauses in Debt Contracts*, 20 REV. ACCT. STUD. 1596, 1632–34 tbl.9 (2015) (observing that financial covenants typically lack a notice-and-grace period).

119. See, e.g., Wright, *supra* note 118, at 222 (observing that a default "automatically results in the release of the lenders from their obligation to lend new money unless the Majority Lenders waive the Default"); cf. *id.* at 57 (defining a "[d]efault" as "any event or circumstance . . . which would (with the expiry of a grace period, the giving of notice, the making of any determination under the [financing agreement] or any combination of any of the foregoing) be an Event of Default").

120. *K.M.C. Co. v. Irving Tr. Co.*, 757 F.2d 752, 754 (6th Cir. 1985).

121. *Id.* at 759. Although the borrower was not actually in breach, the lender technically had the right to cut off the funding because the line of credit was uncommitted.

122. *Reyes v. Wells Fargo Bank, N.A.*, No. 10-01667, 2011 WL 30759 (N.D. Cal. Jan. 3, 2011).

inferred a right to notice and a reasonable grace period by virtue of the implied covenant of good faith and fair dealing, reasoning that although “[i]t is true that the termination provision allows [lender] to foreclose on [borrower’s] home at any time, without notifying [borrower] . . . the Agreement gives [lender] such unfettered discretion in connection with its purported contract obligations that it is illusory unless the Court implies a covenant of good faith and fair dealing into it.”¹²³

As a matter of good faith contracting, which includes reasonableness in enforcement,¹²⁴ this Article proposes that courts should find that enforcement of severe remedies for secondary defaults should require notice and a reasonable grace period (for example, at least 30 days or more if needed) to enable the borrower to try to cure the default. Because the obligation of good faith is implied in every contract,¹²⁵ that notice-and-reasonable-grace-period requirement—if courts agree that it represents good faith¹²⁶—would automatically become part of every financing agreement.¹²⁷

This proposal would not be perfect. At least in the United States, some lenders might oppose it, favoring an immediate Event of Default followed by automatic acceleration of the debt¹²⁸ before the borrower has an opportunity to file a bankruptcy petition, which would suspend the enforcement of remedies.¹²⁹ That strategy, however, should be less important for a secondary default which, by definition, is unlikely to threaten the firm’s viability (and thus would be unlikely to motivate a borrower to file a bankruptcy petition in response).¹³⁰

Another possible imperfection is that conditioning secondary-default remedies on notice and a reasonable grace period presumes that curing the default within any realistic

123. *Id.* at *16. *Cf.* *Van Gemert v. Boeing Co.*, 520 F.2d 1373, 1383–84 (2d Cir. 1975) (holding that a redemption notice published in *The Wall Street Journal*, but not also mailed, did not conform to the debenture holders’ reasonable expectations); Larry A. DiMatteo, *Equity’s Modification of Contract: An Analysis of the Twentieth Century’s Equitable Reformation of Contract Law*, 33 NEW ENG. L. REV. 265, 348–54 (1999) (arguing that reforming a contract to impose reasonable terms promotes the stability of financing arrangements).

124. *See supra* notes 94–96 and accompanying text.

125. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. L. INST. 1981) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”).

126. Admittedly, courts might not always agree. *Cf.* *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1358 (7th Cir.1990) (disagreeing with the Sixth Circuit’s decision in *K.M.C.*, and upholding the right of a lender to discontinue financing at any time based on a strict contractual interpretation); Steven J. Burton, *Good Faith in Articles 1 And 2 of the U.C.C.: The Practice View*, 35 WM. & MARY L. REV. 1533, 1537 (1994) (arguing that the UCC should not be interpreted by “relational obligations” that are not specified in the parties’ agreement).

127. Other possible ways to establish a norm that enforcement of severe remedies for secondary defaults should require notice and a reasonable grace period might include changing the American Bar Foundation’s Model Debenture Indenture provisions; including the proposal in a Restatement; or modifying the UCC.

128. Clive Wells & Amin Doulai, *Till Default Do Us Part: Facility Agreements and Acceleration*, 28 BUTTERWORTHS J. INT’L BANKING & FIN. L. 571, 575 (2013) (observing that some lenders now deliberately negotiate for automatic acceleration as a result of any Event of Default).

129. 11 U.S.C. § 362(a). *Cf.* Wells & Doulai, *supra* note 128 (differentiating incentives under U.S. and U.K. bankruptcy law and discussing 11 U.S.C. § 362).

130. *See supra* notes 17–22 and accompanying text. At least from the standpoint of remedies, that strategy also should be less important for a lender with a below-market interest rate for which, in bankruptcy, the debtor might treat the lender’s claim as unimpaired, thereby preserving that low rate and reinstating the loan’s original maturities. *See* 11 U.S.C. §§ 1124(2)(B) & (2)(E).

grace period is feasible. Some secondary defaults might not, however, be curable.¹³¹ For example, a borrower that fails to purchase mandated insurance coverage could not cure by buying the insurance *after* the occurrence of a fire or flood.¹³² Likewise, a borrower may be unable to cure a covenant to maintain and preserve its financial records after such records are destroyed.¹³³ Nor may it be feasible to cure a covenant to timely pay taxes on certain property once a payment delay results in a tax sale of the property.¹³⁴

Notwithstanding these imperfections, conditioning the enforcement of severe remedies for secondary defaults on notice and a reasonable grace period should provide a meaningful remedy that, in most cases,¹³⁵ would avoid imposing hardships on borrowers and third parties.¹³⁶ As observed, courts should consider using the obligation of good faith to infer this remedy in financing agreements.¹³⁷

131. *Compare In re Orlando Tennis World Dev. Co.*, 34 B.R. 558, 562 (Bankr. M.D. Fla. 1983) (holding that the substitution of borrowers as obligors under a prepetition loan did not impair the lender from reinstating the debt), *with* JPMorgan Chase Bank, N.A. v. Charter Commc'ns Operating, LLC (*In re Charter Commc'ns*), 409 B.R. 649, 651–52 (Bankr. S.D.N.Y. 2009) (referring to lender's allegations of technical defaults as capable of impairing reinstatement of the debt). Many agreements also involve “make-whole” premiums, where the borrower must return the lender to its pre-default state to cure. *See In re MPM Silicones, LLC*, 531 B.R. 321, 335 (S.D.N.Y. 2015), *aff'd in part, rev'd in part and remanded sub nom. Matter of MPM Silicones, LLC*, 874 F.3d 787, 792 (2d Cir. 2017) (discussing “make-whole” premiums).

132. However, it may be possible to backdate flood insurance, for example, where any damage during a gap in coverage is not readily apparent (such as with mold). *See Cannon v. Wells Fargo Bank, N.A.*, No. 12-1376, 2013 WL 3388222, at *5 (N.D. Cal. July 5, 2013).

133. *See, e.g.,* Bishop v. Kinard (*In re Kinard*), 518 B.R. 290, 306 (Bankr. E.D. Pa. 2014) (denying the discharge of a debtor's bankruptcy case for failure to maintain and preserve financial records after some records were destroyed in a flood).

134. *In re Pineda-Pineda*, 510 B.R. 648, 653–54 (Bankr. D. Or. 2014). Related to the proposition that some non-monetary covenant defaults might not be curable, at least one court has ruled that a cure “must completely ameliorate the default” *Sara Lee Household & Pers. Care UK, Ltd. v. Almay, Inc.*, No. 92 Civ. 2042, 1992 WL 309572, at *3 (S.D.N.Y. Oct. 9, 1992). If the lender is harmed by the default notwithstanding a technical cure, that court might enforce breach remedies. *See id.* at *4. For instance, even if a borrower complies within the applicable grace period after default to grant collateral to secure a loan, that technical compliance may be insufficient to avoid remedies if a third party's competing lien attached to the collateral within the grace period (giving the third-party higher priority). *See generally* David K. Duffee & Adam C. Wolk, *Curing a Default: When Is It Too Late?*, MAYER BROWN (Oct. 25, 2017), <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2017/10/curing-a-default-when-is-it-too-late/files/updatecuringadefaultwhenisit-toolate1017v2/fileattachment/updatecuringadefaultwhenisittoolate1017v2.pdf> (on file with the *Journal of Corporation Law*). Those scenarios, however, are very limited.

135. Other than cases in which secondary defaults are not curable. *See supra* note 134 and accompanying text.

136. Residential mortgage-loan agreements, for example, often condition the enforcement of severe remedies for secondary defaults on notice and a reasonable grace period. Typically, these agreements require lenders to issue a formal written notice of default and to provide borrowers with a cure period—commonly not less than 30 days—before the acceleration of debt or foreclosure. The following language represents a sample such requirement: “Lender shall give notice to Borrower prior to acceleration following Borrower's breach of any covenant or agreement in this Security Instrument The notice shall specify: (a) the default; (b) the action required to cure the default; (c) a date, not less than 30 days from the date the notice is given to Borrower, by which the default must be cured; and (d) that failure to cure the default on or before the date specified in the notice may result in acceleration of the sums secured by this Security Instrument and sale of the Property.” Adam T. Sherwin, *Paragraph 22 of the Standard Mortgage*, SHERWIN L. FIRM (Feb. 10, 2016), <https://sherwinlawfirm.com/paragraph-22-of-the-standard-mortgage/> (on file with the *Journal of Corporation Law*).

137. *See supra* notes 125–28 and accompanying text.

2. Charging Default Interest.

Charging default interest, the original past-practice remedy for secondary defaults,¹³⁸ could be another possible lower cost alternative remedy. It would be reasonable, helping to compensate the lender for the default and motivating the borrower to try quickly to cure the default. Although this remedy would have to be specifically negotiated—ideally ex-ante but possibly as part of an ex-post negotiation¹³⁹—by the parties to financing agreements, it would offer an alternative to harsher remedies that, if enforced, could cause the borrower’s failure. Being voluntarily agreed and not causing the borrower’s failure (which could harm third parties), that alternative should be economically efficient.¹⁴⁰

Charging default interest also would be practical. Not all courts may be willing to enforce remedies, based only on a secondary default, that could cause a borrower’s failure. As discussed, the current state of the law on enforcement of remedies for secondary defaults is unsettled.¹⁴¹ Furthermore, the trend may well be heading against enforcement. Comment E to § 205 of the Restatement (Second) of Contracts,¹⁴² for example, uses *Shell Oil Co. v. Marinello* to illustrate the good faith obligation. In that case, the Supreme Court of New Jersey applied the duty of good faith to bar the termination of a lease where the lessee’s default consisted of relatively minor mismanagement of a gas station.¹⁴³

Courts generally respect contractual provisions that require borrowers to pay a higher rate of interest after a default.¹⁴⁴ That higher rate might be an increment above,¹⁴⁵ or perhaps even a multiple of,¹⁴⁶ the non-default rate. The higher rate could continue to accrue from the default date until the secondary default has been cured.

A very high default rate might be viewed, however, as liquidated damages. Contract law generally permits “liquidated damages” clauses that “provide in advance the damages

138. See *supra* note 55 and accompanying text.

139. Cf. *infra* notes 157–68 and accompanying text (discussing the post-default negotiation of alternative secondary-default remedies).

140. See *supra* notes 101–03 and accompanying text.

141. See *supra* notes 37–39 and accompanying text.

142. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. e (AM. L. INST. 1981).

143. *Shell Oil Co. v. Marinello*, 63 N.J. 402, 410–11 (N.J. 1973). The Superior Court first observed that the lessee “was, by virtue of Shell’s dominant position in their relationship and the legal structure of the agreements whose terms he could not vary, compelled to rely upon Shell’s good faith in living up to these expectations.” *Shell Oil Co. v. Marinello*, 120 N.J. Super 357, 374 (N.J. Super. Ct. L. Div. 1972). A lending relationship often has a similar structure, with the lender being a major financial institution and the borrower being unable to vary the terms of the financing agreement.

144. Cf. *In re Beltway One Dev. Grp., LLC*, 547 B.R. 819, 830–31 (B.A.P. 9th Cir. 2016) (respecting the accrual of default interest even during the pendency of a bankruptcy case). The European Union likewise respects default interest as a remedy for the late payment of taxes. Ilse De Troyer, *Default Interest in the Event of Late Payment of Taxes*, 15 WORLD TAX J. 12 (2023).

145. See, e.g., *In re Gen. Growth Props.*, No. 09-11977, 2011 Bankr. LEXIS 2857, at *9 (Bankr. S.D.N.Y. July 20, 2011) (highlighting a default interest rate which was 2% over the non-default rate).

146. Cf. *Bank of N.Y. Mellon Tr. Co. v. Campus Vill. Saginaw*, No. 14-023086, 2014 Mich. Cir. LEXIS 330, at *24 (10th Cir. Ct. Saginaw Cnty. 2014) (“[I]nterest shall accrue at a rate . . . equal to . . . the Contract Rate plus 5% per annum.”); *Cappelli v. Schuster*, No. 652129/2020, 2021 N.Y. Misc. LEXIS 907, at *6–7 (N.Y. Sup. Ct. Mar. 3, 2021) (noting a default rate triple the non-default rate).

that are to be payable in the event of breach”¹⁴⁷ The amount of damages, however, must be reasonable: “unreasonably large liquidated damages [are] unenforceable on grounds of public policy *as a penalty*.”¹⁴⁸ In setting the increment or multiple for a default rate, therefore, lenders should be wary to avoid a rate that could be viewed as “extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.”¹⁴⁹

A possible argument against charging default interest as an alternative remedy is that, historically, default interest had been bypassed in a race for the bottom.¹⁵⁰ Reinstating that remedy, however, would unlikely be bypassed again if, as this Article also proposes, courts condition the enforcement of severe remedies for secondary defaults on notice and a reasonable grace period.¹⁵¹ That would give borrowers the opportunity¹⁵² to try to cure the secondary default, thereby preventing lenders from using it to bargain for collateral.¹⁵³

3. *Requiring Parties in Good Faith, After Default, to Try to Negotiate Reasonable Alternative Remedies*

As discussed, the voluntary negotiation of alternative secondary-default remedies has been largely unproductive.¹⁵⁴ Involuntary negotiation may be more productive, however. For example, a court could refuse to enforce—or a statute could prohibit enforcing—severe breach remedies post-default until the parties have attempted, in good faith, to negotiate reasonable alternatives. At least one jurisdiction has promulgated such a statute: the state of Maine precludes its courts from issuing a final foreclosure judgment until the parties have engaged in a mediation program.¹⁵⁵

Involuntary negotiation may be more productive because it would help fairly to balance the parties’ negotiating power. Recall that, post-default, a borrower that negotiates voluntarily would risk bankruptcy and possible liquidation if it fails to reach a deal,

147. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (AM. L. INST. 1981). *See also* Priebe & Sons v. United States, 332 U.S. 407, 411 (1947) (“When [liquidated damages clauses] are fair and reasonable attempts to fix just compensation for anticipated loss caused by breach of contract, they are enforced.”) (citations omitted).

148. RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (AM. L. INST. 1981) (emphasis added) (“Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.”). English law similarly permits reasonable liquidated damages. *Kemble v. Farren* (1829) 130 Eng. Rep. 1234 (C.P.). It also, similarly, treats clauses that impose disproportionate forfeitures as unenforceable penalties. *See Cavendish Square Holding BV v Talal El Makdessi*, [2015] UKSC 67.

149. *See Cavendish*, [2015] UKSC 67, [20]. Of course, requiring a borrower to pay a reasonable rate of default interest is much less of a penalty than, for example, accelerating the debt.

150. *Cf. supra* notes 58–59 and accompanying text (explaining why including secondary defaults as Events of Default could advantage a lender by maximizing its potential remedies).

151. *See supra* note 128 and accompanying text.

152. *But cf. supra* note 131 and accompanying text (discussing possible feasibility limits on a borrower’s ability to cure a secondary default).

153. *Cf. supra* note 52–59 and accompanying text (observing that that bargaining power motivated the race to the bottom).

154. *See supra* note 46 and accompanying text (discussing why pre-default voluntary negotiation has been unproductive); *see supra* notes 49–50 and accompanying text (discussing why post-default voluntary negotiation has been unproductive).

155. *See* ME. REV. STAT. ANN. tit. 14, § 6321-A (2021).

whereas that failure would not threaten creditor viability.¹⁵⁶ Conditioning the enforcement of creditor remedies on good faith negotiation would give debtors greater bargaining power.

The parties might consider a range of reasonable alternative remedies. These could include, for example, negotiating a waiver (with or without a waiver fee),¹⁵⁷ a forbearance agreement, an amendment to the financing agreement,¹⁵⁸ an out-of-court restructuring of the defaulted loan,¹⁵⁹ or a combination of these.¹⁶⁰ An unsecured lender, for instance, may be willing to waive the breach in return for receiving collateral.¹⁶¹

Negotiating alternatives, nonetheless, can be tricky. There is no assurance that parties, even negotiating in good faith, will reach an agreement¹⁶² (although if the interest rate on a breached loan is above the then-market rate, the negotiation might be easier because most lenders should want to keep favorably priced loans in place).¹⁶³ Negotiations will also be subject to practical constraints; the borrower's ability to grant collateral, for example, might be subject to a negative pledge covenant.¹⁶⁴

156. See *supra* notes 49–50 and accompanying text.

157. Cf. Kelvin C. W. Chen & K. C. John Wei, *Creditors' Decisions to Waive Violations of Accounting-Based Debt Covenants*, 68 ACCT. REV. 218, 221 (1993) (observing that lenders sometimes waive accounting-based secondary defaults entirely).

158. See Clifford W. Smith, Jr., *A Perspective on Accounting-Based Debt Covenant Violations*, 68 ACCT. REV. 289, 292 (1993); Amy Patricia Sweeney, *Debt-Covenant Violations and Managers' Accounting Responses*, 17 J. ACCT. & ECON. 281, 291 (1994) (documenting instances where default firms granted lenders "security interest in previously unpledged assets in consideration for . . . amendments to violated covenants"); Amir Sufi, *Bank Lines of Credit in Corporate Finance: An Empirical Analysis*, 22 REV. FIN. STUD. 1057, 1078 n.9 (2009) (noting the theory that "actual covenant violations represent situations in which firms were unable to obtain an amendment to avoid violation"). Such an amendment might, for instance, impose constraints on the borrower's behavior. Cf. *infra* notes 171–73 and accompanying text (discussing potentially similar restrictions on the borrower's activities).

159. For example, a lender might resize the loan to correspond with the borrower's changed capacity to pay. See, e.g., *Wonderland Shopping Ctr. Venture Ltd. P'ship v. CDC Mortg. Cap., Inc.*, 274 F.3d 1085, 1094 (6th Cir. 2001).

160. See, e.g., *PNC Bank, N.A. v. Dana Transp., Inc.*, No. 16-CV-7797, 2022 WL 3701441, at *3 (S.D.N.Y. Aug. 26, 2022), *rev'd and remanded on other grounds*, No. 23-7272, 2024 WL 4662987 (2d Cir. Nov. 4, 2024) ("Between June 2010 and January 2013, the parties entered into multiple waivers, forbearances, and/or amendments to the [loan agreement] in which Lenders agreed, among other things, to waive certain events of default in exchange for certain concessions and releases from [borrower].").

161. See, e.g., Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights and Firm Investment Policy*, 92 J. FIN. ECON. 400, 401 (2009) (observing that lenders sometimes have responded to the breach of relatively minor obligations by requesting collateral). This bargain may be especially attractive because unsecured lenders typically receive repayment of only a fraction of their loan in a borrower's bankruptcy. Although receiving collateral would not necessarily benefit an already secured lender (though it could benefit an under-secured lender by increasing the collateral protection), such a lender might not want to accelerate its loan because the collateral has reduced its repayment risk.

162. Cf. A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075, 1092 (1980) (discussing the uncertainties of trying to resolve disputes); Osnat Jacobi & Avi Weiss, *The Effect of Time on Default Remedies for Breach of Contract*, 35 INT'L REV. L. & ECON. 13, 13 (2013) (observing that even assuming parties can reach a negotiated agreement, the "pie" may not be distributed equally between them).

163. See, e.g., *XXIII Cap. Ltd. v. Decade, S.A.C., LLC*, No. 1:17-cv-6910, 2018 U.S. Dist. LEXIS 156918 (S.D.N.Y. Sep. 13, 2018).

164. Thomas C. Mitchell, *The Negative Pledge Clause and The Classification of Financing Devices: A Question of Perspective*, 60 AM. BANKR. L.J. 153, 155–56 (1986). In appropriate cases, though, the author's experience

Furthermore, there is uncertainty whether attempting to negotiate alternatives would be economically efficient. Some scholars contend that renegotiating a contract after default often generates the same outcome that the non-breaching party would receive if a court awarded expectation damages for breach.¹⁶⁵ This leads to disagreement over which would be more efficient: renegotiating or enforcing the contract.¹⁶⁶ That disagreement would be compounded where a default could cause a firm's failure that results in third-party harm, greatly adding to the costs.¹⁶⁷

This Article does not propose that the law should formally require parties, after default, to try to negotiate reasonable alternative remedies. It would be difficult and potentially costly to prove that a failed negotiation proceeded in good faith, thereby justifying enforcement of remedies. Furthermore, negotiating alternatives might not be economically efficient. This Article leaves open, however, the possibility that a court might decide on a case-by-case basis not to enforce severe secondary-default remedies until the parties in good faith have attempted to negotiate reasonable alternatives.

B. Remedies Based on Observations from the High-Yield Debt Market

Developments in the high-yield debt market suggest at least four less harsh remedies for secondary defaults. These developments reflect that “high-yield debt has a financial covenant structure that is different from the one discussed in the existing literature.”¹⁶⁸ Certain high-yield debt covenants do not shift control rights to creditors but, instead, provide remedies that “restrict actions of the borrower if the financial covenant threshold is crossed.”¹⁶⁹ Market participants sometimes refer to these covenants as “cov-lite”;¹⁷⁰ they also sometimes refer to those remedies as prohibiting certain “restricted activities.”¹⁷¹

Those remedies—which (as with default interest) would have to be specifically negotiated by the parties to financing agreements—include restricting the borrower's rights to pay dividends on its equity shares, to borrow new money, to make new investments, and to pay any amounts owing on its subordinated debt.¹⁷² These restricted-activities remedies are unlikely to implicate issues of good faith and reasonableness because they should not threaten the borrower's inherent viability.¹⁷³ Accordingly, restricted-activities remedies

is that a borrower could bypass the restrictions of such a covenant by granting collateral equally and ratably to the beneficiary of the covenant.

165. See Jacobi & Weiss, *supra* note 162, at 14 (noting that “[i]f expectation damages can be well specified by the courts, this will replicate the renegotiation outcome”).

166. *Id.*

167. See *supra* notes 73–74, 103 and accompanying text (observing that a realistic assessment of harm, including an efficiency analysis, should take into account any third-party harm).

168. Falk Bräuning, Victoria Ivashina & Ali Ozdagli, High-Yield Debt Covenants and Their Real Effects 2 (June 7, 2023) (last updated on SSRN June 17, 2025).

169. *Id.*

170. *Id.*

171. Victoria Ivashina, Professor of Law, Harvard Law School, Harvard-Wharton Second Annual Conference on Insolvency and Corporate Reorganization (Sept. 20, 2024) (on file with author) (for more information on the presentation see Bräuning, Ivashina & Ozdagli, *supra* note 168).

172. Bräuning, Ivashina & Ozdagli, *supra* note 168, at 18.

173. Another argument might be that restricted-activities remedies constitute *ex ante* provisions to which borrowers freely choose to adhere. That argument, however, would justify even termination-of-commitment and acceleration remedies.

should be assessed according to their economic efficiency and possible externalities. Consider each such remedy in turn.

1. Right to Pay Dividends

A possible restricted-activities remedy for a secondary default could be to restrict the borrower's rights to pay dividends on its equity shares. As with charging default interest, this remedy would have to be specifically negotiated—again, ideally *ex ante* but possibly as part of an *ex post* negotiation¹⁷⁴—by the parties to financing agreements.¹⁷⁵ Dividend covenants are usually tied to the borrower's profitability and “restrict the distribution of dividends financed by the issuance of debt or by the sale of the firm's existing assets.”¹⁷⁶ Loan agreements may also include “more refined dividend covenants” which specify “the maximum value of dividends for given periods, limiting the frequency of dividend payments, or conditioning the payments on various tests such as credit ratings or financial ratios.”¹⁷⁷

Per the Modigliani-Miller theory of dividend irrelevance, the payment (or nonpayment) of dividends theoretically should have no impact on the value of the firm or its capital structure.¹⁷⁸ If so, restricting a borrower's right to pay dividends should not harm third parties. Accordingly, and being voluntarily agreed,¹⁷⁹ this restricted-activities remedy should be economically efficient.¹⁸⁰ Furthermore, it would incentivize the firm's managers to try quickly to cure the default to re-enable the payment of dividends because, in the real world, nonpayment of dividends could impair the stock price.¹⁸¹ Restricting the borrower's right to pay dividends therefore should be a reasonable alternative remedy.¹⁸²

2. Right to Borrow New Money

Second, lenders may restrict firms from borrowing new money.¹⁸³ These restrictions might increase economic efficiency, such as by preventing the borrower from assuming excessive debt (thereby reducing the borrower's default risk), incentivizing the borrower's efficient use of capital, and decreasing the borrower's cost of capital. On the other hand, these restrictions might reduce economic efficiency by obligating the borrower to rely on

174. *Cf. supra* notes 154–67 and accompanying text (discussing the post-default negotiation of alternative secondary-default remedies).

175. *See supra* notes 140–42 and accompanying text.

176. Remus D. Valsan & Moin A. Yahya, *Shareholders, Creditors, and Directors' Fiduciary Duties: A Law and Finance Approach*, 2 VA. L. & BUS. REV. 1, 46 (2007) (citation omitted).

177. *Id.*

178. Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411, 412–15 (1961).

179. *See supra* note 177 and accompanying text.

180. *See supra* notes 102–106 and accompanying text.

181. *Cf. Adam Hayes, Dividends: What They Are, How They Work, and Important Dates*, INVESTOPEDIA, (Sept. 8, 2025), <https://www.investopedia.com/terms/d/dividend.asp> [<https://perma.cc/5Z36-LK96>] (“A steady track record of paying dividends makes stocks more attractive to investors.”).

182. *Cf. supra* notes 94–96 and accompanying text (observing that good faith requires reasonableness in enforcement).

183. Presumably, that restriction would not apply to borrowings under outstanding financing commitments. If that restriction applied to such borrowings, it would have the effect of terminating a financing commitment, thereby jeopardizing the borrower's viability.

more costly forms of financing (such as the sale of equity or assets) and reducing its flexibility to pursue advantageous investment opportunities. The ultimate impact on economic efficiency is unclear.

3. *Right to Make New Investments*

A third possible restricted-activities remedy for a secondary default could be to restrict borrowers from making new investments. This remedy could prevent a borrower from making risky or unadvisable investments, but it could also prevent a borrower from pursuing profitable investments. Again, the ultimate impact on economic efficiency is unclear.

4. *Right to Pay Amounts Owed on Its Subordinated Debt*

Yet another possible restricted-activities remedy for a secondary default could be to suspend the borrower's right to pay amounts owing on its subordinated debt. High-yield subordinated debt often includes language that deeply subordinates the debt under specified circumstances, which could include a secondary default.¹⁸⁴ Ordinary subordinated debt agreements, however, rarely include similar language.¹⁸⁵

Accordingly, outside of the high-yield debt market, a secondary-default remedy that suspends the borrower's right to pay amounts owing on its subordinated debt would almost certainly require a borrower to amend its outstanding subordinated debt agreements to conform to that remedy. Absent such an amendment, the borrower's failure to pay its subordinated debt when due would constitute a repayment default—which would itself, justifiably, trigger severe remedies. Such an amendment, on the other hand, could not be assured and could raise the borrower's cost of issuing subordinated debt. Furthermore, the borrower may have to agree to increase the interest rate on existing subordinated debt as a quid pro quo for an amendment.

Restricting a borrower's right to pay amounts owing on its subordinated debt thus presents significant legal complications and costs. This Article does not recommend it.

C. *Summarizing the Recommendations*

In summary, this Article recommends two remedies inspired by past responses: conditioning the enforcement of severe remedies for secondary defaults on notice and a reasonable grace period,¹⁸⁶ and charging a reasonable default rate of interest that would accrue from the default date until the secondary default has been cured.¹⁸⁷ It also recommends a restricted-activities remedy based on observations from the high-yield debt market: restricting the borrower's rights to pay dividends on its equity shares.¹⁸⁸

184. See generally PEI ALT. INSIGHT & MILBANK, UNDERSTANDING HIGH-YIELD BONDS, <https://www.milbank.com/a/web/17909/HYB-Milbank-digi.pdf> [<https://perma.cc/6SU2-FZB8>].

185. The above observation is based on the author's extensive experience with (including testifying in court as an expert witness on) subordinated debt agreements.

186. See *supra* Part IV.A.1.

187. See *supra* Part IV.A.2.

188. See *supra* Part IV.B.1.

These three remedies could—and this Article proposes that, preferably, they should be drafted to¹⁸⁹—work together because they provide complementary incentives. Conditioning enforcement on notice and a reasonable grace period would enable the borrower to try to cure the default, thereby avoiding enforcement.¹⁹⁰ Charging default interest would compensate the lender for the default while motivating the borrower to try to avoid creating, and if created promptly to try to cure, the default.¹⁹¹ Restricting dividends would further incentivize the borrower to try to avoid creating and promptly cure the default.¹⁹² As shown, these remedies would satisfy the criteria that should, normatively, govern the enforcement of secondary-default remedies.¹⁹³

D. Pricing Loans to Avoid Needing Secondary-Default Provisions

Some data suggest that lenders might be able to price their loans to offset the risk of potential financial defaults, thereby obviating the need to include secondary-default provisions that tie to financial risk.¹⁹⁴ Pricing loans to offset the risk of potential financial defaults—effectively trading a higher return for macroeconomic risk—helps to explain the long-term decline in corporate defaults. Notably, the average default rate within the corporate bond market has consistently decreased for more than a century.¹⁹⁵

The ability to price loans to offset the risk of potential financial defaults can be attributed to the development of more accurate economic forecasting models.¹⁹⁶ Moreover, credit-default swap spreads—which measure the difference in yields between corporate debt instruments and similar maturity United States government securities¹⁹⁷—have further enabled parties to align loan pricing more closely with financial default risk.¹⁹⁸

These loan-pricing improvements do not, however, obviate the need to include secondary-default provisions in financing agreements. Those provisions typically involve non-financial risks such as a delay in paying taxes on, or insuring, property or in delivering audited financial statements or a decline in the value of current assets.¹⁹⁹ Nothing suggests that pricing can accurately offset such non-financial risks.

189. As discussed, although courts could consider using the obligation of good faith to infer the notice-and-reasonable-grace-period remedy, the other two remedies would have to be specifically negotiated by the parties to financing agreements.

190. See *supra* notes 116–20 and accompanying text.

191. See *supra* notes 138–39 and accompanying text.

192. See *supra* note 181 and accompanying text.

193. Recall that those criteria are good faith, reasonableness, economic efficiency, and (avoiding) material externalities. See *supra* Part III.

194. Cf. *infra* note 199 and accompanying text (observing that pricing might not serve to accurately offset non-financial risks).

195. Kay Giesecke et al., *Corporate Bond Default Risk: A 150-Year Perspective*, 102 J. FIN. ECON. 233, 238 (2011) (reporting a consistent decrease from 1866 to 2008). Even during the Great Depression, the average default rate during the worst three-year period was only 12.88%, compared to 1873–1875, when the average default rate was 35.90%. *Id.* By 2000–2002, the average default rate had dropped to 6.15%. See *id.*

196. See *id.* (examining the extent to which default rates can be forecast).

197. See generally Simon Gilchrist & Egon Zakrajšek, *Credit Spreads and Business Cycle Fluctuations*, 102 AM. ECON. REV. 1692 (2012).

198. See Dragon Yongjun Tang & Hong Yan, *Market Conditions, Default Risk and Credit Spreads*, 34 J. BANKING & FIN. 743, 744 (2010) (explaining risks of default in “more volatile economic environment[s]”).

199. See *supra* notes 18–23 and accompanying text; *supra* notes 33–35 and accompanying text.

CONCLUSIONS

This Article examines a critical but largely unexplored issue in contract law: whether secondary defaults—those that are relatively minor or technical and do not involve debt repayment, as illustrated in Appendix 1—should justify enforcing severe contractual remedies. The Article analyzes this issue in the context of loan and other financing agreements,²⁰⁰ which provide that secondary defaults can trigger Events of Default, enabling lenders to terminate financing commitments, accelerate the maturity of a borrower's outstanding debt, and foreclose on collateral. The enforcement of any of those Event-of-Default remedies almost certainly would lead to the borrower's bankruptcy and potential failure, thereby imposing undue hardships on the firm, its shareholders, creditors, and employees, and possibly also the public.

After examining the precedents concerning loan and other contract enforcement, the Article constructs a normative analytical framework that takes into account the criteria—good faith, reasonableness, economic efficiency, and limiting material externalities—that should govern the enforcement of contractual remedies. Comparing those precedents and that framework, the Article argues that the mere occurrence of a secondary default should not justify imposing severe Event-of-Default remedies.

The Article then uses the precedents and normative framework, as well as empirical financial market observations, to analyze a range of possible alternative remedies, and recommends three. First, it encourages courts to find that good faith—which is implied in all contracts—should condition the enforcement of severe secondary-default remedies on notice and reasonable grace periods, thereby giving borrowers an opportunity to try to cure the default (thereby avoiding enforcement). The Article also proposes that parties consider substituting two remedies for traditional Event-of-Default remedies. One substitute remedy—charging a higher interest rate until the default is cured—would compensate lenders for any increased risk while motivating borrowers to try to avoid creating, and if created, to try to quickly cure, any such default. The other substitute remedy—restricting dividends during that same period—would further incentivize borrowers to try to avoid and, if created, to promptly cure the default.

The Article also examines whether lenders could price their loans to offset the risk of secondary defaults, thereby avoiding the need to include (and enforce) secondary-default remedies. Although accurate economic forecasting models and the use of credit-default swap spreads could help to price loans to offset the risk of financial defaults, these loan-pricing improvements would not address—and therefore could not offset—the non-financial risks that are typical of secondary defaults. That makes the Article's focus on alternative remedies for those defaults all the more important.

200. Scholars may wish to consider expanding this Article's inquiry beyond that context, to examine more generally under contract law whether secondary defaults should justify enforcing severe remedies. In the merger-and-acquisition (M&A) context, for example, buyers have claimed that contract breaches, including false or misleading representations and warranties by the seller, should enable them to assert remedies not only for damages but also "to obtain 'rescission' of the transaction—literally an unwinding of the acquisition in which the purchase price is refunded by the sellers to the buyer and ownership of the target is transferred back to the sellers." Frederick R. Fucci, *Arbitration in M&A Transactions: Laws of New York and Delaware Part III*, 71 DISP. RESOL. J., no. 4, 2016, at 1, 11. In a relatively recent example, Carenet Healthcare Services sued a digital health care company it acquired in 2021, claiming fraud and misrepresentation discovered months after the deal closed. *InfoMedia Grp. Inc. v. OM Invest Inc.*, No. 2022-0848 (Del. Ch. Sept. 21, 2022). However, the case settled in April 2024.

APPENDIX 1—TYPICAL EXAMPLES OF SECONDARY DEFAULTS

The first step in applying this Article's recommendations is to determine whether a default constitutes a secondary default or one more serious. This Appendix 1 provides guidance for making that determination. To that end, it reviews representative covenants in financing agreements and explains how their breach could constitute secondary defaults.

The following review of representative covenants is divided, in accordance with financing industry practice, into affirmative covenants and negative covenants. An affirmative covenant "is used to remind the borrower they should be doing certain activities to maintain the financial health and well-being of the business."²⁰¹ A negative covenant "is used to create boundaries for the company and its owners."²⁰²

In analyzing which of these affirmative and negative covenants impose obligations, the breach of which would be secondary defaults, recall that a secondary default is a "relatively minor or technical default[] not involving debt repayment."²⁰³ None of these covenants involves debt repayment *per se*. Therefore, its breach should be classified as a secondary default to the extent the consequences of the breach are relatively minor or technical.²⁰⁴ Accordingly, whether a breach should be classified as a secondary default may depend not only on the type of covenant but also on the nature, and thus consequences, of the breach.²⁰⁵

A. Representative Affirmative Covenants

Requirement to pay all business and employment-related taxes.²⁰⁶

To the extent the failure to pay any such taxes subjects the borrower to a fine or other penalty but does not materially impair the borrower's ability to operate its business, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.²⁰⁷ Nonetheless, a failure to pay taxes on property pledged to a lender as collateral could be more serious than a secondary default if such failure threatens to cause the collateral's loss by tax sale.²⁰⁸

Requirement to maintain current financial records and to deliver to the lender for review certain types of reports such as a Certified Public Accountant's compiled, reviewed, or audited financial statement each year.²⁰⁹

To the extent the failure to maintain such financial records and to annually deliver such reports is unintentional or not within the borrower's control and does not materially

201. Holly Magister, *Loan Covenant Examples*, EXIT PROMISE, <https://exitpromise.com/loan-covenants-examples/> [https://perma.cc/8TM8-MZMK].

202. *Id.*

203. *See supra* notes 5–6 and accompanying text.

204. Note that covenants in public indentures may be more limited than in other financing agreements. The covenants listed in this Appendix 1 are representative of covenants in financing agreements generally.

205. That classification also might depend on whether the borrower is a covenant-breach recidivist. At some point, a repeat offender should become subject to severe remedies.

206. Magister, *supra* note 201 (discussing types of loan covenants).

207. *Cf. supra* note 19 and accompanying text (characterizing a borrower's delay in paying property taxes as a secondary default).

208. *See supra* note 17 (observing the consequences of a loss of insurance coverage on collateral).

209. Magister, *supra* note 201 (discussing types of loan covenants).

impair the borrower's ability to operate its business, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.²¹⁰

Requirement to maintain adequate insurance policies for the business.²¹¹

To the extent the failure to maintain such insurance is unintentional or not within the borrower's control and does not materially impair the borrower's ability to operate its business, its consequences would be relatively minor or technical—and thus the failure would be a secondary default. Nonetheless, a failure to pay insurance premiums covering property pledged to a lender as collateral could be more serious than a secondary default if such failure causes a loss of insurance coverage.²¹²

Requirement to maintain the business entity in good standing with the state where it is formed.²¹³

To the extent the failure to maintain the borrower in good standing in that state is unintentional or not within the borrower's control and does not materially impair the borrower's ability to operate its business, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

B. Representative Negative Covenants

Limiting the total amount of indebtedness for the business.²¹⁴

To the extent the failure to limit that amount of indebtedness is unintentional or not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due,²¹⁵ its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Restriction on distributions and/or dividends paid to shareholders.²¹⁶

To the extent the failure to comply with this restriction is unintentional or not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Restriction on or forbidding management fees paid to related parties.²¹⁷

To the extent the failure to comply with this restriction is unintentional or not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Prevention of a merger or acquisition without the lender's permission.²¹⁸

210. *Cf. supra* note 20 and accompanying text (characterizing a borrower's delay in delivering audited financial statements as a secondary default).

211. Magister, *supra* note 201 (discussing types of loan covenants).

212. *Cf. supra* note 17 (observing the consequences of a loss of insurance coverage on collateral).

213. *See* Magister, *supra* note 201.

214. *Id.*

215. A breach that causes the borrower's insolvency or inability to pay its debts as they become due should not be a secondary default because such breach would impair the creditors' prospects of repayment. *Cf. supra* notes 5–6 and accompanying text (explaining that a secondary default would not involve debt repayment).

216. *See* Magister, *supra* note 201.

217. *Id.*

218. *Id.*

To the extent the occurrence of such a merger or acquisition is not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Prevention of investment in capital equipment, real estate, or other businesses without the lender's permission.²¹⁹

To the extent the occurrence of such an investment is unintentional or not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Prevention of the sale of assets without the lender's permission.²²⁰

To the extent the assets sold are less than a substantial part of the borrower's assets and such sale neither materially changes the nature of the borrower's business nor causes the borrower to become insolvent or otherwise unable to pay its debts as they become due, the sale's consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Failure to maintain a specific or targeted debt service coverage ratio.²²¹

To the extent the failure to maintain such a debt service coverage ratio is unintentional or not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Prevention of a decline in the value of current assets.²²²

To the extent the failure to prevent such a decline is unintentional or not within the borrower's control and does not cause the borrower to become insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical—and thus the failure would be a secondary default.

Restricting liens, mortgages, or other encumbrances on assets.²²³

These covenants, often called “negative pledge covenants,” restrict those types of encumbrances in order to avoid diluting the repayment of unsecured creditors. They therefore tend to be included in “[c]ontracts governing unsecured debt.”²²⁴ Because these covenants are designed to (at least indirectly) protect debt repayment, their breach should be more serious than a secondary default. Nonetheless, breaches that are unintentional, not within the borrower's control, and not material in amount—such as the occurrence of a mechanic's lien if an employee of the borrower brings a company car to a mechanic for repairs—should only constitute a secondary default.

The foregoing review of representative affirmative and negative covenants does not cover a provision sometimes included within Events of Default: a borrower's board

219. *Id.*

220. *Id.*

221. See Magister, *supra* note 201.

222. Cf. *supra* note 22 and accompanying text (characterizing that decline as a secondary default).

223. See William W. Bratton, *Bond and Loan Covenants, Theory and Practice*, 11 CAP. MKTS. L.J. 461, 470–71 (2016).

224. *Id.* at 470.

authorizing, but not taking actual steps to initiate, the filing of a bankruptcy case.²²⁵ Because such an authorization neither subjects the borrower to bankruptcy law nor makes the borrower insolvent or otherwise unable to pay its debts as they become due, its consequences would be relatively minor or technical. Such an authorization therefore should constitute a secondary default, not an Event of Default.

225. See *supra* note 22 and accompanying text (discussing how a board authorization for bankruptcy is a secondary default); First Expert Report of Steven L. Schwarcz, *supra* note 15, 39 (discussing the author's expert testimony about such a board authorization). *But cf.* EVENT OF DEFAULT PROVISIONS IN CREDIT AGREEMENTS (Lexis Practice Note) ("Generally, events of default in a credit agreement are circumstances where: . . . [relating to bankruptcy] the borrower or loan party is the subject of a bankruptcy or other insolvency proceeding or its general financial condition deteriorates such that it is unable to meet its obligations to its creditors in general.").