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Legal Update

Credit Concerns Go Viral – Time to Look At Your Financial Hygiene

The concerns over COVID-19 have arguably been the required trigger — against the backdrop of increasing unease — for market participants to take stock and review their financial arrangements.

Lenders and counterparties must review their finance documents regarding protections and/or vulnerabilities; and, where exposed to industries particularly affected by the COVID-19 outbreak, may consider (i) invoking provisions to demand early repayment and/or to preclude further lending; and (ii) whether there is material benefit in doing so. They should also consider what pre-emptive steps they should take to stave off critical defaults.

Lenders will have to reassess credit risk and aim to maximise returns by pursuing restructuring options when available, while reserving rights and avoiding inadvertent waivers. They should avoid wrongful enforcement, but a readiness to act will be imperative.

Sectoral and industry-based issues, for example relating to travel and/or transport, will often frequently stem from: geographical considerations; China's integral role in a business's operations, whether as supplier or consumer; and restrictions on movement of people and goods generally.

In this overview, we outline some considerations, based on experience through our practices in Asia, the Americas and Europe, regarding:

- Liquidity and working capital reviews;
- Directors' duties;
- Relevant contractual terms and covenants;
- Impact on derivatives;
- Standstill/forbearance arrangements.

General Considerations

The spike in credit concerns heightens the importance of problem loan management. To obtain the best recovery available, lenders should generally avoid rushing to put debtors into liquidation. Giving companies time to restructure their operations and financial position can ultimately improve their ability to service and repay their debts.

Bearing in mind the generally low recovery rate that unsecured creditors obtain from liquidations, workouts will often be a better option as far as maximizing the lenders' return is concerned. However, the threat of liquidation should provide an incentive for debtors to address problems and to agree to cooperate with their lenders.

It is one thing to try to manage the situation once a company has got into financial difficulties. However, taking a proactive approach and identifying problems early is preferred, before they have become so serious as to necessitate restructuring or worse, liquidation.

Whether in good times or bad, lenders should perhaps focus less on perceived security and more on the strength of the underlying business and the cash flows it generates. This of course assumes that debtors have provided, and will provide, correct and accurate information on, and assessments of, their business.

Liquidity Reviews

Lenders and borrowers should alone or collectively consider various aspects regarding the critical issue of liquidity, including:

a. Reviewing their expectations of trading and cash flows, including stress-testing downside scenarios to establish actual and possible needs; and identify what mitigating actions can be taken to preserve cash in the short to medium term.

b. Undertaking formal review of lending, security, guarantee and other assurance-against-loss documents to consider their ongoing efficacy, the strength of and realistic expectations regarding covenants.

c. Considering additional sources of capital to address where cash flow forecasts indicate that liquidity is or will become an issue. Options may include, asset sales; asset-based financing; and equity raisings, in each case where circumstances permit.

Working Capital and Supply Chain

Lenders and borrowers should alone or collectively consider:

a. Customers may delay payments to preserve their cash, while suppliers will want to be promptly paid for shipped or ordered goods.

b. Identifying which key suppliers may be exposed and reviewing the borrower's contingency plans relating to alternative suppliers.

c. Looking at receivables purchase and factoring arrangements, both in terms of the viability of existing arrangements and whether such arrangements can be helpfully introduced if absent.

Distressed Companies and Directors' Duties

The reviews outlined above will also be relevant should action ultimately be instigated against the directors, who would want to demonstrate that their actions were in all the circumstances reasonable.

Directors are required to consider the interests of creditors where the company is doubtfully solvent or is on the verge of insolvency. Issues regarding personal liability for insolvent trading come into play, as does the availability of "safe harbour" defences, if available in the applicable jurisdiction. Directors should seek legal advice in relation to their duties and compliance with company law when the company encounters financial difficulties or a real risk of insolvency.

Relevant legislation may also provide a summary method of enforcing existing duties owed by past and present officers of a company subject to winding-up proceedings. Conduct that may give rise to such liability may include a breach of directors' duties, or claims arising from preferential transactions or fraudulent trading.

Governments around the world may provide relief from certain duties for a limited time, but directors should keep in mind their duties to the company and creditors to avoid risk of liability.

International group company directors need to familiarize themselves with their duties in the relevant jurisdictions pertaining to different companies in the group for which they are officers; and to consider issues on an entity-by-entity basis, rather than taking a group view.

Lending Documents

Parties should review their finance documents with a view to considering their efficacy and relevant provisions at this time, which may include those referred to below.

NON-PAYMENT DEFAULTS

Non-payment will be an event of default and could be an indication of financial distress or insolvency. However, it may also be a matter of liquidity, for example caused by non-payment for goods shipped by an otherwise healthily functioning company.

Borrowers and lenders alike should consider well in advance if new monies are likely to be needed, as it can take time to implement agreement among financiers, noting that rescheduling of debts itself may trigger cross-defaults.

MAC CLAUSES

While material adverse change (**MAC**) provisions are routinely included in loan agreements, they are rarely relied upon, as clear and unambiguous non-payment events (if available) will be preferred.

A loan agreement will often record that a lender has no obligation to lend (and may demand repayment of amounts advanced) if a borrower suffers a MAC, which may refer to a variety of different aspects of the borrower group, its business, operations, property, condition (financial or otherwise), prospects or its ability to perform certain of its obligations under the agreement.

Guidance from the English courts is limited but includes, broadly, the following[1]:

a. MAC provisions will be construed in accordance with usual principles of contractual interpretation;

b. an assessment of the financial condition of a company should normally begin with its financial information at the relevant times and a lender seeking to demonstrate a material adverse change over the period in question should do so by reference to that information — the phrase "financial condition" did not encompass other matters such as the company's prospects or external economic or market changes;

c. an inquiry was not necessarily limited to the company's financial information if there was compelling evidence to show that a material adverse change had occurred;

d. an adverse change would be material if it significantly affected the borrower's ability to repay the loan in question;

e. a change would not be material if merely temporary;

f. a lender could not trigger a MAC clause on the basis of circumstances of which it was aware at the time of the agreement, although it may do so where conditions worsen in a way that makes them materially different in nature;

g. it would be up to the lender to prove the breach.

FINANCIAL COVENANTS

Notably in recent borrower-friendly times, covenant-light facilities returned to favour and so lenders should be aware that in some cases existing covenants may not be breached. Borrowers may also have included cure rights, which, while remedying the covenant position, may have wider adverse consequences for the lender.

CESSATION OF BUSINESS

The current transport impasse and also prohibition on public gatherings are likely to give rise to circumstances triggering potential cessation of business defaults. The LMA/APLMA formats would operate where an obligor, or possibly another member of the corporate group, suspends or threatens to suspend or cease to carry on all or a material part of its business.

AUDIT QUALIFICATIONS

In the current environment, it is conceivable that auditors will take a more cautious view on companies' abilities to continue as going concerns, with the result that either audited accounts may suffer from qualifications (which may trigger an event of default) or require additional company support by way of a parent guarantee or standstill (which themselves may breach covenants, absent prior consent).

More fundamentally, technical defaults (and cross defaults) may even occur where audits cannot get done on time because of the extensive travel restrictions.

1 *Grupo Hotelero Urvasco SA v Carey Value Added SL* [2013] EWHC 1039 (Comm)

EXPROPRIATION

Some finance agreements will include expropriation provisions, which may, for example, cover business issues arising from any action a governmental, regulatory or other authority undertakes. Such provisions would not generally be at the forefront of the parties' minds, but the possible escalation of general state intervention appears to be increasing.

Other Contractual Remedy Considerations

Companies may need to consider whether their contract has a *force majeure* clause, exculpating the supplier when there are unintended events. A *force majeure* event is one which materially impacts, or renders impossible, the performance of the contract. This relief is usually the suspension of the parties' obligations under the contract during the *force majeure* event, and, if the event continues for a prolonged period, the right to terminate the contract. Parties would have to show that the COVID-19 outbreak falls within the scope of the *force majeure* clause specifically drafted for that contract and that the event has materially affected, or rendered impossible, the performance of the contract.

The China Council for the Promotion of International Trade has provided suppliers of goods in China with over 3,300 certificates concerning inability to supply due to *force majeure* events, covering contracts worth US$38 billion. The effect of such certificates remains questionable. Unless the contract provides that such a certificate is conclusive as to the existence of *force majeure*, it is likely the courts (or an arbitrator or adjudicator) will have to decide if the event in question constitutes *force majeure*. However, if the forum for the dispute is in China, the local courts are likely to be sympathetic to suppliers' assertions in defence.

If the contract does not contain a *force majeure* clause, the parties may seek to rely on the common law doctrine of "frustration". However, this will only be available in limited circumstances where performance of the contract has become truly impossible, or where there has been a fundamental change of circumstances from those in contemplation at the time the contract was entered into. A contract will terminate if frustrated and the parties will be released from all future obligations. Simply increasing cost or difficulty of performance is not enough and successful claims of contract frustration have been limited.

These are issues to consider in connection with the liquidity and perceived strength of customers' underlying businesses. Contractual *force majeure* is likely to be absent from lending agreements and the common law frustration doctrine is unlikely to apply, as the outbreak generally will not make payments of money impossible or change the fundamental premise of the commercial transaction.

Assuming the early resumption of performance is the goal, collaboration coupled with a sound understanding of the contractual position will be preferred. However, inevitably in some cases the economic disruption will be so great that lenders will not be able to sit back. In any event, one should start preparations and reviews now to address expeditiously materially increased credit risks associated with borrowers, as these continue to surface.

Derivatives

Companies may trade over-the-counter derivatives for a variety of reasons such as foreign exchange, interest rates, commodities and equities. It is also common, for example, in leveraged loan transactions to require the borrower to enter into hedging for a minimum proportion of its term facilities, to mitigate against upward fluctuations in interest rates and/or adverse exchange rate movements.

The volatility in the financial markets, which is likely to continue, can lead to margin calls which cause a cash squeeze on counterparties; and disruptions are likely to be felt in connection with derivatives, both as components of lending transactions and general over-the-counter positions.

CALLS FOR COLLATERAL

A party that is out of the money pursuant to an over-the-counter derivative may be required to provide collateral to cover potential losses. A sudden and unexpected movement in the market can impose a heavy collateral liability on a counterparty on a daily basis, based on the market value of their trading positions, which could continue accumulating. The affected counterparty may reach a point where it cannot meet collateral calls.

A failure to post additional collateral following formal demand may lead to the termination (close-out) of all outstanding derivatives transactions, at which point the non-defaulting party will have the right to value the terminated transactions and require the defaulting party to pay the net amount calculated to be due.

CROSS DEFAULTS

Cross-default clauses will be found in facility agreements, and sometimes bonds, providing for the lender (or bondholders) to require immediate repayment of all amounts due if there is a default regarding "Financial Indebtedness." In LMA and APLMA loans, "Financial Indebtedness" may include indebtedness for or in respect of any derivative transaction entered into in connection with protection against or to benefit from fluctuation in any rate or price. This language could capture failures to pay under derivatives transactions, and a default arising from a derivative trade could therefore risk cross-defaults regarding a derivatives counterparty's other financial exposures.

A borrower's otherwise viable business may fail if such a default were to cause all borrowings to become immediately repayable. Lenders will need to assess the impact of triggering cross-default clauses where it could lead to the cash flow insolvency of the borrower and ultimately reduce recoveries (particularly if inadequately secured).

BUSINESS DAYS

Earlier this year, the Chinese Government issued a directive to extend the Lunar New Year holiday in an effort to reduce the spread of COVID-19.

This action raises the consideration of 'business days': payments and deliveries under derivatives and their associated documents will only be due on business days in the relevant jurisdictions. If a public holiday is unexpectedly declared in an area that is affected by COVID-19, this might mean the payment or delivery is no longer due on the anticipated days, and calculation periods may be affected.

NOTICES

Unscheduled holidays and also country lockdowns may affect the ability to serve notices effectively on a particular date, because the notice cannot become effective until the next business day or if it is in fact impossible to deliver the notice in the prescribed manner. If the specification in the schedule is for courier, transmission by facsimile will not comply with the contractual requirements.

FORCE MAJEURE

The 2002 ISDA Master Agreement does contain a type of *force majeure* clause (Section 5(b)(ii)).

There are a number of material considerations to be reviewed, which are beyond the scope of this article, and the specific terms of agreements and relevant circumstances will ultimately determine parties' rights and obligations under them. On a high level basis:

- *Force majeure* applies in the absence of any more specific market disruption provisions, which would need to be considered first.
- *Force majeure* will generally be a termination event rather than an event of default under the 2002 ISDA Master Agreement, with different consequences from termination following an event of default. For example, there may be an impact on the valuation of the terminated contracts.
- The clause may apply not just on the payment or delivery date itself, but also on an anticipatory basis, looking at whether the payment or delivery would be impossible or impracticable if it were due on that day. No doubt its application will be highly fact-specific.

Standstill/Forbearance Arrangements

Consensual restructurings may become necessary but will generally require buy-in from multiple stakeholders and a standstill during which initial discussions can take place without the threat of precipitative action from a single creditor.

The choice of jurisdiction chosen in which to pursue the restructuring may be critical, for example as regards the availability of a moratorium against proceedings, rescue financing incentives and the ability to trade out as a going concern, as well as the possibility of recognition of final agreements within multiple jurisdictions.

Standstill agreements will typically need to deal with:

a. Suspension of current payment obligations and defaults;
b. Maintenance of facilities without acceleration but possibly being placed on-demand;
c. Agreement not to set-off credit balances;
d. Restrictions on transfers of debt positions pending agreement (or adherence of transferees to standstill arrangements);
e. No unilateral enforcement by any creditor party to the standstill;
f. Termination if the standstill agreement is breached, insolvency proceedings are launched against the debtor group or a restructuring is successfully implemented.

During the standstill period:

a. Cash flow requirements will be monitored and assessed;
b. An asset disposal programme or other cost cutting measures may be devised;
c. New monies will be considered, together with any corresponding security available;
d. Changes to management may be made if necessary.

The ensuing restructuring agreement may include:

a. A debt haircut;
b. An interest holiday;
c. The conversion of debt to equity;
d. The issuance of a convertible bond, intended to align the interests of creditors and shareholders.

Conclusion

A whole host of issues will surface for lending counterparties as liquidity continues to tighten.

You should initiate careful review and strategic planning as soon as possible, considering cash management and liquidity issues and the potential domino effect of jumping on defaults rather than evaluating and managing the implications.

Governments, banks and other bodies are also offering and/or encouraging relief. Monitoring what is on offer from time to time and the implications as lender or borrower will be important.

How We Can Help

Challenging possible alternatives with your advisers as sounding boards is often a worthwhile strategy.

Our Restructuring team globally is market leading and has decades of experience in supporting corporates, lenders and other stakeholders in difficult times across our offices in Asia, the Americas and Europe.

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