

COVID-19: IT'S TIME TO REVISIT FINANCING AGREEMENTS

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The global pandemic caused by the novel coronavirus (“**COVID-19**”) is having a chilling impact on the normal day-to-day lives of people worldwide. The virus has not only created a major public health crisis, but has led to significant disruption and deceleration in several areas of the economy, including the financial markets, manufacturing and supply chains, and global trade. As of the date of this publication, economic losses due to COVID-19 are continuing to mount, and governments and central banks in the world’s largest economies are implementing stimulus packages, so far collectively exceeding US\$7 trillion, to counteract the disruption caused by COVID-19 and stave off a global recession.

In this challenging context of economic volatility, financial institutions and their clients will need to evaluate how the COVID-19 pandemic will affect existing financial agreements and relationships, and how new relationships will be shaped by current market conditions. The following provides an overview of common issues that may arise under financing agreements, and highlights some best practices for financial institutions and their clients to consider in navigating the uncharted waters of the COVID-19 pandemic and its effect on the economy.

Key Contractual Issues

Force Majeure

Many financing agreements contain “*force majeure*” clauses, the basis of which is to allocate risk and to ensure that no party should be required to perform or be held liable for failing to perform obligations under the agreement where extreme circumstances outside the control of such party prevents them from doing so.

With the economic uncertainty of COVID-19, debtors may look to rely on a *force majeure* clause to excuse non-performance or non-compliance with certain provisions of their financing agreements.

Typically, a *force majeure* clause will specify certain events that would constitute a “*force majeure*”. To determine whether this clause would be applicable, debtors would first need to determine whether the COVID-19 pandemic falls within the scope of the clause. The COVID-19 outbreak could be interpreted to fall under listed events such as public health emergencies, pandemic/communicable disease outbreak or quarantines. Alternatively, debtors may attempt to rely on broader *force majeure* events such as “Acts of God”,

certain government or administrative action, supply chain disruption, or general events beyond the reasonable control of the parties. Depending on the specificity of the clause, it may be difficult to determine whether a debtor may be able to rely on such clause. Additional analysis must be done to determine if any other action must be taken in order to rely on the provision. This may include any notice requirements that might be triggered, any duty to mitigate or remedy the situation imposed on either party, any threshold of causation that must be established by the party relying on the clause, or any pre-determined consequences or outcomes specified by the provision.

Given that there is no concept of an implied *force majeure* clause at common law, the actual language of the clause, if included, is determinative. Absent a *force majeure* clause, a court would render a decision on whether to excuse an impacted party from contractual performance based on other available justifications for non-performance, such as impossibility and frustration. To determine impossibility, it is not enough to establish that an event simply made performance more expensive or difficult. Frustration is a slightly different concept where a party's primary purpose for entering into an agreement no longer exists due to some intervening event. Establishing that frustration of a contract has occurred is difficult to achieve and involves an extensive factual analysis.

Interestingly, the government of the People's Republic of China ("**China**") has taken a unique approach to the issue of *force majeure* clauses by issuing *force majeure* certificates for those businesses that apply for assistance. These certificates provide a certification from the government that external circumstances had occurred which prevented Chinese companies from fulfilling obligations under their contracts. However, although this approach may be deemed enforceable domestically in China, it remains unclear whether it will become an accepted approach in other countries.^[1]

Material Adverse Change/Material Adverse Effect

It is common for financing agreements to contain the concept of a material adverse change ("**MAC**") or material adverse effect ("**MAE**"). An example of a standard definition for such concept is set out below:

"Material Adverse Effect" means a material adverse effect on (a) the business, assets, operations, prospects or condition, financial or otherwise, of the Loan Parties, taken as a whole, (b) the ability of any Loan Party to perform any of its Obligations, (c) the Collateral, the Lender's Liens on the Collateral or the priority of such Liens, or (d) the Lender's ability to enforce its rights or remedies under any of the Loan Documents.

Typically, these concepts provide thresholds for compliance with certain covenants, representations or warranties, but may also affect whether or not certain obligations need to be performed under the agreement.

For instance, it may be required that no MAC or MAE shall have occurred as a condition precedent to any advance or borrowing under a credit facility and, in some instances, a MAC or MAE may be a separate event of default. Thus, for both lenders and borrowers, a MAC or MAE may significantly affect obligations under a financing agreement.

MAC and MAE definitions are often broad and typically do not specify any events in particular which might trigger such clause, unlike a *force majeure* clause discussed above. There is also limited case law considering MAC or MAE clauses. As a result, there is often uncertainty around what may constitute a MAC or MAE under a given financing agreement, and a detailed factual analysis is once again necessary to assess a party's risk upon the occurrence of a suspected MAC or MAE. Regardless of the uncertainty, lenders should be cognisant that if an event has occurred that may constitute a MAC or MAE, it is also likely that other aspects of the agreement have been or will be affected, including triggering a breach of certain financial or other covenants or an event of default, which may warrant addressing the broader agreement as a whole, rather than just relying on the specific MAC or MAE clause.

Breach of Covenants

COVID-19 may have a negative impact on a debtor's ability to adhere to covenants, particularly financial covenants, in financing agreements. Covenant breaches will have ripple effects in financing agreements that may result in an event of default (discussed below). As debtors evaluate how best to respond to this time of uncertainty and make changes to their business that they might not otherwise have considered, continuing review of their compliance with covenants is essential.

Most financing agreements have restrictions related to a debtor's material contracts, which require adherence with such contracts and prohibit their termination. Debtors, particularly those impacted by supply-chain disruptions, may find it difficult to comply with these covenants. The uncertainty amidst the COVID-19 outbreak may also cause debtors to re-evaluate their capital structure, business model and debt holdings, which may affect a debtor's compliance with negative covenants dealing with dispositions, fundamental changes and distributions to shareholders and affiliates. For instance, if a debtor switches production from one type of product to another, this may trigger a breach of any covenants requiring such debtor to conduct its business as it was conducted on the date of entering into the agreement.

Financial covenants are included in financing agreements as an early warning system to Lenders of any financial distress of their debtors. Any financial difficulty experienced by debtors because of COVID-19 may affect compliance with interest coverage ratios and other financial benchmarks related to cash flow.

COVID-19 may also affect physical delivery obligations. For example, security and pledge agreements usually require debtors to ensure that collateral such as share certificates and negotiable instruments be physically

delivered to lenders as part of their ongoing obligations. In the current climate, office closures, post-office availability, and other practical issues may impact whether or not debtors can comply with such provisions, or whether lenders are available to receive such items.

Additionally, financing agreements will typically require debtors to provide notice of any event or change in condition that has resulted, or could be reasonably be expected to result, in a MAC or MAE. As debtors review their financial condition and covenants, careful consideration should be given to the specific wording of all reporting covenants, and to the timing of when any substantive change in their financial condition is anticipated to occur, in order to determine when a MAC or MAE may be triggered and ensure that notice is provided in accordance with the requirements of their financing agreements.

Events of Default

As mentioned above, non-compliance with covenants will have a domino effect within a financing agreement and will often result in an event of default if the non-compliance is not remedied. Non-demand financing agreements generally contain events of default that give lenders certain remedies to reassess the entire financing arrangement. If triggered, an event of default could result in suspension of the availability of certain facilities, termination of commitments by the lenders and/or acceleration of the maturity of the facilities and demand for repayment of all outstanding loans. Given the disruptive economic impact of COVID-19, the increased likelihood of non-payment of principal and/or interest, breaches of covenants, and cross default with other debt or material contracts all increase the probability of triggering an event of default. Additionally, any inability to pay creditors when payments become due may give rise to insolvency concerns that could also trigger a number of standard bankruptcy and insolvency-related events of defaults in financing agreements.

Debtors are typically required to provide lenders with written notice of the occurrence of any default or event of default.

By contrast, in demand financing agreements, events of default are often not included as triggers, and debtors are subject to the lender's sole discretion to terminate the agreement and demand repayment at any time.

Unscheduled Non-Business Days

A financing agreement will typically have a specific definition of what constitutes a "business day", which generally refers to days that the lender or banks are open for business. Payment dates, interest periods, maturity dates and other periods within financing agreement are often determined by reference to "business days". Financial institutions are generally not open for business on national holidays, therefore, any change to such holidays may have a direct impact on financing agreements, as recently illustrated in China due to COVID-19.

On January 30, 2020, the government of China announced that the Lunar New Year holiday, which was expected to run from Friday, January 24, 2020 to Thursday, January 30, 2020 (inclusive), was extended to run to Sunday, February 2, 2020. This extension was implemented as a measure to contain the spread of COVID-19 in the country.^[2] As a result of this extension, Chinese equity markets, commercial banks and foreign exchange markets, which were expected to open on Friday, January 31, 2020, remained closed until Monday, February 3, 2020. Parties in China were required to consider the impact of this unexpected holiday and how to deal with situations where (i) payments were scheduled to be made during the new holiday period; (ii) observations in respect of underlying interests were to be made during the new holiday period; and (iii) agreements terminated or expired during the new holiday period.

Although, no other jurisdiction has declared a new holiday as a measure to contain COVID-19, parties should make contingency plans in case there is such a declaration. Generally in China, the market was able to deal with the situation by looking to the business day conventions chosen by the parties to financing agreements, including the definition of “business day” (or with respect to ISDA agreements the default following business day convention set out in the 2006 ISDA Definitions) or applying the market disruption events relating to observing values for underlying interests (particularly for equity derivatives).

Considerations and Next Steps

In light of the current situation faced by the financial sector, it is crucial for financial institutions and their clients to be actively engaged in order to properly assess their respective risks going forward. Below are a number of preliminary steps that parties should consider taking to ensure they are prepared to weather this period of uncertainty:

1. **Review Agreements.** All parties to financing arrangements should conduct a review of their primary loan documents to assess whether or not any of the potential contractual issues discussed above (or any other issue) may apply.
2. **Amendments and Waivers.** To the extent it is determined that a contractual issue has arisen that may frustrate the contract, prevent either party from performing their obligations, trigger a breach or event of default, or cause any other problematic situation, the parties should first look to see if such issue can be resolved by an amendment to the agreement that is agreed to by the parties, or by a waiver granted by the lenders to alleviate the problem temporarily.
3. **Establish Lines of Communication.** In addition to open lines of communication with clients, lenders and financial institutions should also actively engage with, and monitor public communications from, any applicable regulators and the various levels of government to ensure that they remain aware of the latest recommendations, orders and policies, and to ensure compliance with any guidelines or restrictions that

may be imposed during this time.

4. **Assess Market and Regulatory Risk.** As the external environment undergoes rapid change, financial services sector participants should be constantly evaluating the surrounding financial market and assessing their exposure to both market and regulatory risks, especially in the context of their existing agreements.
5. **Enforcement Options.** If a financial institution deems that any of its financing agreements, or any environmental factors, give rise to an issue that is unlikely to be remedied, it should begin to evaluate what enforcement options remain available, either under contract or through litigation. It is important to note that enforcement options may be limited by the closure of certain businesses, courts or government offices, thus changing the recourse available to financial institutions in the short term.

Conclusion

Ultimately, the COVID-19 pandemic has created an environment full of economic uncertainty. The primary objective for financial institutions and their clients is to continually evaluate risk exposure stemming from existing financial arrangements and any new arrangements they propose to enter into, as well as any risk stemming from the external environment that may affect their relationships going forward.

McMillan LLP can assist with all aspects and stages of the analysis discussed above, from reviewing contractual arrangements, to assisting in any efforts to remedy issues that arise, and to helping with the commencement of enforcement proceedings. Please contact our Financial Services Group with any COVID-19 related questions or concerns.

by Kathy Martin, Shahen Mirakian, Michelle Boodhoo and Anthony Pallotta

[1] CNBC, [China invokes 'force majeure' to protect businesses – but the companies may be in for a 'rude awakening'](#).^[ps2id id='1' target=""]

[2] CNBC, [More than half of China extends shutdown over virus](#).^[ps2id id='2' target=""]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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