Legal Update

How the COVID-19 Outbreak Might Affect Your English Law Loan Documentation

6 April 2020

The coronavirus COVID-19 outbreak poses challenges to almost every sphere of business giving rise to a vast number of legal issues demanding quick and careful decisions.

This note focuses on some of the key questions lenders and borrowers may have as to the effect of the coronavirus COVID-19 pandemic and the supportive measures implemented in this regard in LMA loan and ISDA derivative documentation governed by English law.

1. May a borrower defer or waive the repayment of principal or interest payments as a result of difficulties experienced due to coronavirus COVID-19?

1.1. Force Majeure

1.1.1. English law has no general principle of "*force majeure*" which operates in the absence of a contractual provision, so it is unlikely that general provisions of law would permit borrowers a defence to a claim to enforce repayment of principal or interest based on the coronavirus COVID-19 outbreak. Each case depends, of course, on its facts, including the wording of the loan agreement and the context in which the loan was made.

1.1.2. Standard LMA loan documentation does not provide for force majeure provisions excusing the borrower's payment and other obligations. Generally, in the absence of specific contractual permission to allow a borrower to defer interest due to lost income (such as under a payment waterfall or PIK mechanism), a borrower remains liable to repay the principal and pay scheduled interest , despite cashflow difficulties caused by events outside its reasonable control.

1.1.3. The ISDA 2002 Master Agreement does contain a force majeure clause – please see paragraph 5 below for further detail.

1.2. "Frustration" of Contracts

1.2.1. Under the English law "*doctrine of frustration*", a contract may be altogether *discharged* (terminated)when something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil the contract, or transforms the obligation to perform into a radically different obligation from that undertaken at the moment of entry into the contract. This does not

merely create a temporary defence to a claim for performance, but leads to a complete discharge of the contract.

1.2.2. However, this doctrine exists within narrow confines. Given that there is no known precedent for a borrower being able to invoke an event such as coronavirus COVID-19 as a defence to a claim for payment, it is hard to predict whether English courts would in fact support a frustration defence. For instance, a change in economic conditions, or circumstances making a contract more expensive to perform, are examples of cases which the English courts have held do not frustrate a contract.

1.3. *Material Adverse Change*

1.3.1. COVID -19 may be regarded as a "*material adverse change*" or "*MAC*" on the borrower's financial position and its ability to perform, so an event of default may be triggered based on coronavirus COVID -19 if a respective MAC clause is included in the loan agreement. Normally, the occurrence of an event of default gives the lender the right to demand accelerated repayment of the loan from the borrower. So a MAC clause, will not assist the borrower in finding an excuse for delaying its loan repayments and interest payments.

1.4. *Grace Periods, "Disruption Events" and Non-Business Days*

1.4.1. It is not uncommon for loan agreements to provide a short grace period where a payment is not made because of a material disruption to payment or communication systems or to those financial markets required to operate in order for payments to be made or other obligations to be performed, and the disruption is beyond the control of the parties (defined in the LMA standard documents as a "Disruption Event"). It seems possible, although perhaps not that likely, that a Disruption Event may occur as a result of coronavirus COVID-19 "lockdown" measures. Typically, loan agreements will provide that if any such disruption occurs, the lender or the agent is entitled to require consultation about agreeing necessary operational or administrative changes to the loan facility.

1.4.2. It is conceivable that, as a result of coronavirus COVID-19-related restrictions on movement, markets may be altogether closed for business, in which case there would be short-notice unscheduled non-business days. Some standard loan agreements contemplate this by stating that where a payment is due on a date which is not a business day, the payment day will be the next business day unless that day falls in the next calendar month, in which case it will be the previous business day. An emergency market closure near the end of a calendar month could, if literally interpreted, move the payment date to a date in the past. Such a rather extreme set of circumstance would need to be addressed either by the parties mutually or by emergency legislation.

2. What legal provisions exist for a Russian borrower to seek protection against action by its lenders?

The coronavirus COVID-19 pandemic seriously affects businesses in various spheres which may result in some form of borrower insolvency. However, on March 25, 2020 the Russian President proposed a six -month moratorium on the filing of bankruptcy petitions in respect of affected businesses. Should this initiative materialise, the lenders' ability to commence insolvency

proceedings against a defaulting obligor will be limited,[1] We are monitoring any developments in this regard.

3. Tax gross-up

3.1. LMA loan documentation requires borrowers to make payments free of any tax deduction and, where a deduction is required by law, to increase the relevant payment due to the lenders for the amount of such deduction thus making the net amount paid to the lenders the same as if no deduction was made. This concept is referred to as a tax gross-up.

3.2. By default 20% withholding tax is applied to payment of interest to foreign entities unless other rule is provided by a double tax treaty ("DTT"). Today Russia is a party to DTTs with most OECD (including typical holding) jurisdictions[1] which exempt interest paid to a foreign entity from Russian withholding tax. As a part of the supportive measures introduced by the Russian President, it is proposed to revise some of the DTTs with typical holding jurisdictions and provide for a 15% withholding tax on dividends and interest payable to non-Russian entities or, if other party to a DTT refuses to revise respective clauses, terminate the DTT. Should Russian DTTs be terminated or otherwise disapplied further to the presidential proposal, tax gross-up undertakings are likely to be triggered. As a consequence, where expressly provided for under standard LMA loan documentation, borrowers that are required to gross up payments owed to lenders in jurisdictions that will no longer benefit from Russian DTTs may become entitled to voluntarily prepay their outstanding loans owed to such lenders.

3.3. However, this initiative remains subject to further analysis, once the list of DTTs subject to amendment or termination is determined and the respective draft amendments or terminations are published.

4. May lenders demand early repayment of a term loan or terminate or suspend the availability of a loan facility as a result of COVID-19?

4.1. Standard LMA loan agreements for committed facilities typically contain a variety of provisions permitting the lender to suspend drawdowns and/or to demand early repayment of advances already made and/or to put them onto a demand basis. Such provisions include event of default clauses to which borrowers may be exposed in the current circumstances. These may include breaches of financial covenants, insolvency events such as inability to pay debts as they fall due, the start of a formal insolvency proceedings, suspension of business operations, or more specific events relating to the borrowers' business. Loan agreements would usually entitle lenders to take the above actions on the occurrence of any of these events of default.

4.2. In this context, reference is often made to "material adverse change" clauses, but this is usually misplaced. Whether a material adverse change has occurred will be determined in each case based on the wording of the relevant clause or definition and the factual circumstances. However,

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[1] For more information please use the following link https://www.dlapiper.com/en/russia/insights/publications/2020/04/legal-impact-of-the-coronavirus-covid-19-pandemic-in-russia/

[1] Including, among others, the following jurisdictions: Cyprus, the Netherlands, Luxemburg, Singapore, Switzerland, Ireland and others.

the English courts will not lightly find that a material adverse change has occurred and will generally require the relevant event to impact on the ability of the borrower to perform its obligations under the loan agreement.

4.3. The position is different where a borrower determines that the current circumstances are sufficiently serious for it to be unable to continue paying and it goes into a formal insolvency process or admits to the lender its inability to perform. In such cases, a discussion may follow with a view to effecting a work-out outside of a formal insolvency process. If a borrower in effect throws in the towel and does not want to continue, then the lender would have no choice and would have to take steps to minimize its losses. Generally, this would include accelerating the repayment of the loan and enforcing any security.

5. ISDA's 2002 *force majeure* clause

5.1. Force majeure is not (unless specially provided) a termination event in the 1992 ISDA Master Agreement, but it *is* in the 2002 agreement. Force majeure is not a commonly-encountered clause in a debt contract because debt contracts are, post-drawdown, what lawyers call *"executed"* contracts – one party has done its side of the bargain by making the loan, and all the significant obligations are on the side of the other party, the borrower. However, swaps, caps and collars are all *executory* contracts i.e. both parties have significant future actual or contingent payment or performance obligations, and they could be hindered.

5.2. The key force majeure clause in the 2002 ISDA Master Agreement is Section 5(2)(ii). In summary, a "Force Majeure Event" is one which, "by reason of force majeure or act of state" results in a party, office or credit support provider being "prevented" from making or receiving a payment (or complying with some other "material provision"), or it becomes "impossible or impracticable" for one of them to make or receive a payment, so long as it is "beyond the control" of the person in question and could not be remedied, after using all reasonable efforts (which will not require the person to incur a loss, other than immaterial, incidental expenses) to overcome the prevention, impossibility or impracticability. While force majeure continues, any relevant obligation is suspended, but after the end of the applicable "Waiting Period" (eight Local Business Days), either party can terminate the contracts, and the close-out payment is calculated on the basis of mid-market quotations i.e. on a no-fault basis.

5.3. There is plenty of scope for interpretation here: what does "force majeure" mean when used in Section 5(b)(ii)? When is something an "act of state"; when is someone "prevented"; when is something "impracticable"; and what as a matter of fact constitutes "reasonable efforts"? All of these terms will need to be considered in determining whether a "Force Majeure Event" has in fact occurred.

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