ALLEN & OVERY

# Covid-19 coronavirus

## Legal Ramifications in Asset Finance

**Covid-19 and its impact on asset finance**

We are in unprecedented times due to a combination of the spread of the Covid-19 virus and the governmental and public responses to it, all of which are causing significant disruption to the transportation sector. Financiers (including lenders, lessors, ECAs, alternative credit providers and credit providers) and lessees, borrowers and sponsors are facing significant issues arising from Covid-19 and this note discusses some of the legal issues facing such parties.

**Defaults and events of default**

Many parties will be experiencing significant cash flow issues; more exposed, weaker businesses and even successful and profitable enterprises may find themselves unable to generate the cash flow needed to service their financial obligations. They may be in breach of contract or close to the edge of being so. Default triggers certain consequences such as repayment of a loan, termination of a lease, the obligation to return a leased asset or to pay damages, or triggering default of other contracts (cross-default). Although English common law addresses issues relating to breach of contract and its consequences, the area is so filled with uncertainty that we always specify expressly in our contracts exactly what an event of default is and what its consequences are. We also often use the concept of a "default" being an event that with the passage of time or giving of a notice will become an event of default. The following sections will consider how the current Covid-19 pandemic intersects with financial contracts.

**Undrawn credit and revolving facilities**

Many airlines and shipping companies have revolving credit facilities that are designed to provide working capital, manage cash-flow or provide general liquidity. These can be drawn on to smooth cash flow and to invest in opportunities; they are often unsecured. In the current environment many businesses are drawing on such facilities to keep operating or make up for falls in revenue from their customers.

Financiers are becoming concerned that they may now be obliged to lend or maintain credit lines to a business that is at greater risk of failure, something that was not anticipated when the financing was originally put in place. Typically credit facilities contain a "draw-stop", a clause that allows them to prevent the borrower drawing down further; in the case of a revolving credit facility the borrower has to repay the loan at the end of each interest period and redraw it if it wishes to continue borrowing (usually this is done by a notional repayment and re-borrowing: the debt is simply rolled over). At the point of roll-over or drawdown, the borrower is usually required to repeat its representations and warranties which typically contain a representation that no material adverse event or material adverse change (see below) has occurred or that no default had occurred or would occur as a result. If the borrower cannot do this, the financiers would then not be obliged to continue lending.

**MAC (material adverse change)**

Many transactions have "material adverse change provisions" (MAC provisions); these trigger obligations, like providing security, or may give rise to a default or a draw-stop. MAC provisions may be drafted quite widely (see below) or may be very narrow (for instance, being limited to the borrower not being able to perform its obligations under the finance documents). The wording will need to be examined carefully in

each case to ascertain the rights of the parties. A very wide MAC provision may be triggered if the relevant event causes a material adverse change in:

- the business or financial condition or prospects of the borrower, lessee or the group of companies to which it belongs;
- the ability of the borrower or lessee to perform its obligations; or
- the effectiveness of any security or guarantees the financier has.

Whether Covid-19 or any of the governmental actions relating to it constitutes a breach of a MAC provision will depend on the interpretation of the exact wording of the MAC provision and how the borrower or the lessee is affected. Triggering a MAC provision is not something to be taken lightly; it requires proper analysis and evidence. Usually if such evidence is available, it is fair to say that the borrower or lessee may well be in breach of other obligations which are easier to prove than relying on a MAC provision. However, a MAC provision can be useful to prevent a borrower drawing on an undrawn credit facility or a lessee taking delivery of an aircraft or a ship and it could be used to pressure the borrower or lessee into renegotiating.

**Possible steps to take**

Imposing a draw-stop or calling an event of default based on a MAC provision or a belief that the other party is in default can be a risky strategy unless the financier is certain of its grounds. Is there anything else it can do?

Many transaction documents give the financier the right to ask the borrower or lessee for information about its business, financial condition, assets or operations, or require it to certify that it is complying with financial covenants, notify it of a default or certify that there is no default. If the documents contain such provisions, a financier might be able to gather sufficient information. Working out what information can be obtained (the borrower or lessee might only have to comply with "reasonable" requests) and how the information might trigger the MAC provision (or any other default or event of default) needs careful thought.

**Force majeure**

From a lessee's or borrower's perspective, they may argue that due to "force majeure" they cannot comply with the strict terms of their contract and that this should prevent an event of default occurring. Force majeure clauses allow a party to suspend performance of the contract if it is prevented by any of a number of specified events such as war, riot, strikes, natural disasters, pandemics and so on. The concept of force majeure is not part of English common law: it must be expressly included in a contract, if it is to apply. It also gets confused sometimes with "frustration" which we will consider further below.

It is unusual to have a force majeure clause in standard banking documents or aircraft or ship financings which will usually make payment an absolute and unconditional obligation with a very limited grace period, if any (a "hell or high water" clause). These clauses place the risk of any future problems with performance of the contract with the lessee or borrower. However, in many commercial contracts, in areas such as project finance, construction, satellite manufacture or shipbuilding, force majeure clauses are more common, particularly in non-finance documents. This reflects the uncertainty that can arise under such contracts, the need for flexibility and a greater sharing of risk between the parties. Financial contracts generally do not price such risks into the bargain.

Assuming there is a force majeure clause in your contract, determining whether the relevant event triggers the clause involves asking a number of questions.

- Is force majeure defined by reference to a specific list of events, is there a list of the sort of events that would qualify or is it not defined at all?
- Does the event which is claimed to be preventing performance of the contract actually come under that definition or list?
- Is the event actually preventing performance or would the party be defaulting anyway? The virus itself may not be preventing performance, but a governmental regulation aimed at preventing travel might be.
- If force majeure is not defined, then there is limited relevant English case law to provide guidance as to what it means.

The party seeking to rely on force majeure to avoid performance of the contract will usually need to show that:

- the event being relied on falls within the wording of the clause and is beyond its control;
- the event makes it unable to perform the contract; and
- there were no reasonable steps it could have taken to avoid or mitigate the event or its consequences.

The English courts will generally construe force majeure clauses narrowly and apply well-trodden rules of contractual interpretation if there is any uncertainty about whether the force majeure clause is triggered and what the consequences are. The underlying principle is to uphold commercial contracts if possible.

Even if force majeure is not in your contract, the other party may raise the issue. Governmental action may attempt to create a situation in which force majeure applies to protect local businesses. It might do this by in effect prohibiting the performance of the contract, for example by shutting down bars or theatres, or by certifying that a force majeure event has happened by issuing "force majeure certificates" to local businesses to exempt them from having to fulfil certain contracts. If the contract is under English law, the first example might well qualify as force majeure, but the second might well not as the certificate in itself is not the event. If there is no force majeure clause in the contract, English law would not imply one in either case, but it might make it harder to enforce the contract strictly in a local court.

So, in considering whether force majeure may apply to a contract, you will need to consider:

- whether the event falls within the meaning of the term in that particular contract;
- whether the event has caused what would otherwise be a breach, and not some other factor;
- whether there are ways of mitigating or working around the event; and
- what the consequences are of triggering the clause, either correctly or incorrectly.

**Frustration**

Force majeure usually refers to circumstances that make it unduly difficult or temporarily impossible to perform a contract. Frustration of a contract under English law refers to circumstances when it is impossible to perform at all and will automatically terminate a contract, leaving each party free to walk away at the point it occurs, with no further obligations. However, it is a very rare event that causes an English law contract to be frustrated. To qualify as frustrating, an event must:

- occur after the contract has been made;

 

- be unforeseeable (an unforeseeable event will not necessarily frustrate a contract, but the event that frustrates a contract must be unforeseeable);
- be beyond the parties' control; and
- make performance of the contract impossible or illegal (more expensive or more difficult is not enough); or
- result in contractual obligations radically different from those contemplated by the parties at the time they entered into the contract.

The problem for a lessee claiming frustration of a lease, or a borrower repaying a loan, as a result of the Covid-19 virus is likely to be that its obligations are largely paying rent, maintaining the aircraft or vessel and insuring it, or repaying the loan. Travel restrictions, the loss of an air operator's certificate, insufficient passengers to make flying economically viable, crew illness, difficulties in recruiting replacement crew or a reduction in employment for a vessel do not render the lease or loan impossible to perform or illegal. Even a law subsequently passed in the lessee's jurisdiction (if it is not England) is unlikely to amount to frustration. Finally, a party cannot "self-induce" frustration by making performance illegal.

**Enforcement**

While this note is not intended to discuss enforcement issues in detail, it is important to bear in mind that when defaults and events of default happen, they trigger the right to enforce security or repossess leased assets. While lenders or lessors may obtain a judgment of an English court, this may not be helpful when trying to enforce in a jurisdiction where the courts might be more sympathetic to an important locally-owned business providing important services or where national law might conflict with English law.

Not enforcing carries risks as well. It is important not to waive any defaults (which could happen if nothing is done once the financier knows of the default). Reservation of rights letters are an important way, if appropriately worded and used, to ensure that the defaults are not accidentally waived, once the financier becomes aware of the issues, thereby preserving the financier's bargaining position.

**Security deposits**

If a lessor has the benefit of security for unpaid rent or maintenance reserves in the form of a letter of credit, it should consider how it might be able to use this if it needs to. The letter of credit will specify how a demand can be made. Usually this involves attending at the issuing or confirming bank with the original letter of credit, a demand prepared in the correct form and any other documentation required by the letter of credit.

Issues that may potentially arise are:

- locating the original letter of credit;
- preparing the demand and getting the right person to sign it; or
- attending at the relevant bank to present the demand.

All of these steps may face hurdles imposed by the lock-downs and travel restrictions which prevent the beneficiary getting the right pieces of paper and people in the right place.

Assuming that the beneficiary can get this far, is the relevant bank branch open? Most letters of credit have to be presented in person before their expiry. If the bank is closed, the terms of the letter of credit might provide for it to be automatically extended but this depends on the set of rules governing the letter of credit and its specific terms. If the bank is closed, it is important to document the attempts to serve a

demand properly to ensure that the beneficiary can show that it has complied with the terms of the letter of credit and is therefore entitled to an extension, if there is a later dispute. The UCP 600, which governs many letters of credit used in trade finance, and also a good many standby letters of credit, allows a paying bank potentially to avoid payment if it is closed due to force majeure at the time the letter of credit is due to expire, unless the relevant article of the UCP 600 has been disapplied. It would therefore be sensible to review standby letters of credit which are due to expire or which might be called on.

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