

Fund Finance Friday



Contractual Considerations in Uncertain Times

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The widespread outbreak of COVID-19 as a global pandemic has rocked the financial sectors and challenged the way we do business. Like many, we view this as a short-term event and believe the long-term outlook for fund finance remains more than promising. Yet it is in these rare times that we find ourselves more closely considering contractual terms to govern uncertainty. We outline here three key topics to address the current disruption: electronic signatures; contractual time limits; and managing potential breaches.

Electronic Signatures

As travel restrictions tighten and firms' work-from-home operations commence, there is a need to provide flexibility and ease in executing legal documents. In the United States, the major regimes that govern electronic signatures are the federal Electronic Signatures in Global and National Commerce Act (ESIGN Act), the Uniform Electronic Transactions Act (UETA), and New York's Electronic Signatures and Records Act (ESRA). Europe has the eIDAS Regulation and the United Kingdom's Electronic Communications Act 2000. These statutes assure the effectiveness and enforceability of electronically signed agreements while providing for their retention and reproducibility.

The ESIGN Act was passed by Congress in 2000 to help spur ecommerce by giving electronic contracts identical legal standing to hand-signed agreements. As a federal law, it regulates business in all 50 U.S. states and interstate commerce. The Act stipulates that although state laws need not mirror the federal legislation, they must give equal protection for electronic documents and signatures. Currently 47 states have adopted the UETA to do just that.

New York's ESRA treats e-signatures similarly to the ESIGN Act and the UETA. While each mandates that an electronic signature must be linked to an electronic record, they do not require a particular method or means for doing so. Instead, the choice of technology or application is left to each business to decide. The most critical consideration is to ensure that you use a secure technology that is not easily manipulated or forged. The second is to inform your counterparties of any restrictions your firm may have on the modes of e-signatures it can accept.

For greater certainty in contracting, parties to an agreement may choose to add an express provision permitting electronic signatures. Often this will be placed in the interpretative section or the counterparts signature section of a primary agreement, such as a credit agreement or limited partnership agreement, and be made to apply to all related documents. The verbiage should indicate that electronic signatures are as binding as manually executed signatures. These clauses can be constructed broadly but take into account any requirements or limitations that an organization might have in the form or format of e-signatures that it can accept.

Contractual Time Limits

Legal documents are filled with timelines: from payment dates to notice periods, from consent timeframes to grace periods. But when is a day not a day? When it's not a "Business Day" as defined in the contract. In the context of COVID-19, market participants should assess the impact that forced business closures could have on contractual time limits. With the proliferation of the present contagion, certain jurisdictions have already begun to announce additional public holidays. And there's no telling if this may recur as the virus spreads.

A customary definition for “Business Day” refers to any day other than a Saturday, Sunday, or other day on which banks are authorized or required to close. Parties should evaluate the effect of potential work stoppages on their obligations under their legal documents. Whether a required payment or disbursement falls on one Business Day or another, and any extension of time that a party may ultimately have to satisfy such obligations, could be lengthened by government-induced shutdowns. On the flip side, a contractual deadline determined by days rather than Business Days may necessitate discussions between the parties to avoid a breach if a cutoff time cannot be met during a business lockout.

For syndicated financings, obtaining required consent or waiver is more complicated than for bilateral deals. Timing issues to keep in mind that could impact such actions include (a) the percentage and number of lenders required to vote, (b) any deemed acceptance or deemed rejection provisions for not providing consent or waiver within a certain timeframe, and (c) any grace periods if requisite lender agreement is not received in time.

Force majeure provisions may also see increased scrutiny. Such clauses are intended to provide temporary or permanent relief to parties for significant adverse situations that are objectively unavoidable. Causes may include earthquakes, floods, extreme weather, computer system malfunctions, civil disorder, labor difficulties, pandemics and other acts of God. While it is uncommon to see these terms in fund finance loan documents, we have recently seen these negotiated into investor side letters and account control agreements.

There are two primary types of force majeure clauses. The first provides for an indefinite period of delay in performance by a party. The second allows a party to completely abdicate performance. The distinction is critical. For example, if such a clause were in an investor’s side letter, we would not view the former formulation as fatal because it only provides additional time to act – it could give the applicable investor extra time to contribute capital. Whereas the second formulation would be of greater concern for a fund or its lender, because it could give the investor a right to cease funding altogether.

Although it might be better to have a specific timeline with the first form of force majeure (for example, no more than five Business Days), this would be quite uncommon, as force majeure clauses are intended to cover situations where the timeline is uncertain. Still, we would generally expect the time period to be relatively short for most types of force majeure events. This is especially the case in the fund finance context, where the parties tend to be sophisticated entities like funds, institutional investors, banks, and law firms with enhanced technology and work-from-home capabilities. Since money moves electronically, most delays should be on the scale of days or maybe weeks but likely not much longer except in the most extreme types of force majeure.

Managing Potential Breaches

Fund finance parties should assess the impact of coronavirus on a borrower’s ability to comply with its covenants. Affirmative covenants that require a borrower to take certain actions tend to have grace periods. Negative covenants, which require a borrower to refrain from particular activities, usually do not. The parties may wish to evaluate the likelihood of a breach ahead of time. It would be prudent to have a waiver in place prior to any breach occurring, to avoid acceleration of the loans and risk of triggering any cross-defaults elsewhere.

If a market participant might be unable to perform a contract as a result of the current pandemic, it would be sensible to assess when it could realistically resume compliance. Communicate early on a good-faith basis with your counterparty to attempt to resolve the situation. Review of the terms for breach in the loan documents should give some direction. Determine if part of the contract can still be performed. Lenders may expect more consent and waiver requests to be submitted, considering the evolving situation, and might want to prepare to deal with such situations on a prospective basis for when they appear.