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COVID-19 Update: The Impact of COVID-19 on Financial Contracts

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The current market volatility arising from the restrictions imposed to reduce the risk of spread of COVID-19 has led many market participants to consider their position under existing contractual relationships, including, assessing their own obligations and whether any potential or actual event of default has occurred in respect of their counterparty. This memo illustrates practical issues to be taken into account by a counterparty to a financial contract in making these considerations using, as an example, a derivative transaction[1].

What do I Need to Diligence Under My Existing Financial Contracts Given Current Events?

Do market closures affect my obligations?

The impact of COVID-19 has led to unprecedented measures being put in place in many jurisdictions around the world which have, or may in the future have, the effect of closing markets in a variety of locations. These closures, and the location of the markets which are subject to closure, will need to be carefully considered to determine their impact on a party's position under a financial contract.

For example, the standard form ISDA Master Agreement (both the 1992 version and the 2002 version) contains a number of provisions which utilise the concept of Local Business Day or General Business Day which are defined, depending on their use, by reference to whether commercial banks or settlement systems are open in various places, locations or cities. These definitions are used to determine the due date for payment obligations, the calculation of interest, and whether a notice has been effectively served. Further, financial contracts may also contain product-specific provisions dealing with market closure, for example, the provisions relating to Pricing Disruption Events and Settlement Disruption Events under ISDA's Equity Derivatives Definitions.

[1] The example of a derivative transaction is used as market volatility can immediately result in margin requirements in transactions with daily mark-to-market provisions. However, as the facts and specific provisions of each contractual relationship will vary from case to case, market participants should seek tailored legal advice.

Do any force majeure provisions affect my obligations?

The expression "force majeure" clause refers to a provision that is commonly found in commercial agreements, by which one (or both) of the parties are entitled to cancel a contract, or are excused from performance of the contract (in whole or in part), or are entitled to suspend performance or to claim an extension of time for performance, upon the occurrence of a specified event (or events) beyond a party's control. The 2002 ISDA Master Agreement, for example, provides for the imposition of a "waiting period" following the occurrence of an Illegality or a Force Majeure Event, among other consequences.

A number of force majeure clauses have been tested before the English courts. The tendency of the courts has been to construe such provisions restrictively or to subject them to implied limitations. The onus is on the party seeking to rely on the force majeure clause to demonstrate that the facts in question fall within its scope, properly construed. Parties are not generally able to rely on a force majeure type provision where the impossibility is self-induced — in this context, compliance with governmental guidance following the outbreak of COVID-19 may be particularly relevant.

It can be crucial to identify any applicable force majeure clauses, and any other provisions dealing with supervening events such as impossibility or illegality, as the availability of protection provided by the clause may be contingent on correctly invoking it (i.e. by following a certain procedure, or by providing notice in a particular manner, within a stipulated time period). Depending on the particular contract, such procedures or formalities may be construed as strict conditions precedent, or merely as intermediate terms, the non-fulfilment of which does not necessarily deprive a party of the right to rely on the clause. Even the party who is not relying on the clause should act with care, for there is a risk it may be held to have waived, or to be estopped from asserting, any non-compliance with the contractual procedures for invoking the force majeure clause.

Will the doctrine of "frustration" excuse non-performance?

The English law doctrine of frustration operates (within narrow confines) to bring a contract prospectively to an end because of the effect of a supervening event. It has been said to arise in circumstances where a supervening event renders the performance of the bargain "radically different", when compared to the considerations in play at the conclusion of the contract. The doctrine is narrow and cannot be lightly invoked before the English courts.

Where express provision has been made in the contract itself for the event which has actually occurred, the contract cannot be treated as frustrated. While boilerplate force majeure provisions in some industry documents may expressly refer to pandemics, such express reference is unusual in ISDAs or other financial contracts. That said, the relevant force majeure event (or impossibility/illegality event) may not be COVID-19 itself, but rather the measures taken by governments to control its spread, and careful consideration is therefore necessary.

A key point to bear in mind is that the doctrine of frustration, if it operates, brings the contract to an end immediately, without more and automatically. It does not require an act by the parties to the contract. The essence of frustration is that it should not be due to the act or election of the

party seeking to rely on it. Given that the consequence of frustration is to discharge and release the parties from all future obligations, its operation may adversely affect the position of an innocent party looking to rely on the future performance of close out provisions under an ISDA agreement. The remedies for frustration are usually restitutionary in nature, i.e. they aim to restore the parties to the position they would have been in had the transaction not been entered into.

My Counterparty is in Default - What Steps do I Need to Take?

What evidence of a cross-default do I have?

Financial contracts may include cross-default provisions allowing a party to declare a default where, although the counterparty is complying with its other obligations under that contract, it is in default under another contract. In considering whether to take steps in respect of a potential cross-default, parties should first consider if they have clear evidence of the relevant cross-default according to the contractual criteria (i.e., not just market rumour - to avoid wrongful termination). For example, if the counterparty has listed debt, notifiable defaults may be discovered through announcements on the relevant stock exchange.

Can I suspend my payment obligations to a defaulting party?

If the contract allows it, the non-defaulting party will need to consider whether, and for how long, it can suspend its payment obligations to a defaulting party under the contract. Such clauses, under derivatives contracts, have been extensively litigated following the Lehman collapse[2]. The English courts ruled that a non-defaulting party under an ISDA Master Agreement can, under section 2(a)(iii), refuse to make payments to a defaulting party while a potential or actual event of default is continuing. Payment obligations remain suspended (potentially indefinitely), while the condition precedent (that no potential or actual event of default has occurred in respect of the other party) remains unfulfilled, and will revive once the default is cured or the non-defaulting party elects to terminate the transaction. Payment obligations are not extinguished by reason of maturity of the transaction (that is, the last date fixed for contractual performance), and amounts continue to accrue while the condition is unfulfilled. The English courts have refused to imply terms into the ISDA Master Agreement requiring the non-defaulting party to terminate the transaction and pay the defaulting party.

Do I risk waiving a default if I do not enforce immediately?

Subject to any express provisions to the contrary, if an event of default occurs under an ISDA Master Agreement, the non-defaulting party may, at any time while the event is continuing, and provided that it has not affirmed the agreement (for example, by continuing to perform it after becoming aware of the default) close out all the outstanding transactions under it.

It is a question of fact whether an affirmation or waiver has occurred following a breach of contract. If the non-defaulting party continues to perform without protest for a significant period after learning of an event of default, this may be construed as an election to abandon its right to

[2] For example, Lomas and others v JFB Firth Rixson Inc and others [2012] EWCA Civ 419

terminate[3], notwithstanding contractual provisions expressly providing that a party's delay in exercising its rights will not operate as a waiver or preclude it from subsequently exercising those rights.

In cases of implied affirmation there will usually need to be some sort of unequivocal act from which it may be inferred that the party intends to go on with the contract regardless of the breach. Mere inactivity after breach does not of itself amount to affirmation[4]. To avoid any suggestion that the contract has been affirmed during periods of negotiation and forbearance from enforcement, parties are advised (ideally with input from counsel) to make clear and express reservations of all rights under the contract and to consider the appropriateness of standstill agreements which could be put in place.

How do I effectively deliver a termination/default notice?

In current circumstances surrounding COVID-19, there may be practical difficulties and uncertainties surrounding the effective service of contractual notices, such as:

- If the address states a particular floor of a building, does putting a notice through a letter box, or leaving it with security, constitute valid delivery?
- If the recipient's office is closed, has a fax actually been delivered to a responsible employee?
- If registered mail is sent, is it enough that delivery is attempted?
- If it is impossible to deliver using any of the methods that the contract prescribes, how likely is the court to find an implied term in the contract that notice may be delivered in another way?
- What if the contractual methods for delivery are impracticable or inconvenient, but not impossible?
- If my contract provides that it terminates automatically upon certain events, should I still notify the counterparty, to avoid doubt about the date and time of termination?

When exercising a contractual right under English law that depends on service of a written notice (including the right to terminate), failure to strictly comply with any express formal requirements and/or pre-conditions in the contract will normally invalidate the notice. A prematurely issued notice to terminate a contract, for instance, may be found to be wrongful and constitute a renunciation of the contract. An incorrectly issued notice (to the wrong address or via the wrong method of communication), on the other hand, may be found to be invalid and ineffective altogether.

[3] See Tele2 International Card Co SA v Post Office Ltd [2009] EWCA Civ 9, where on the facts there was continued performance of the agreement for nearly a year without any protest or reserve of any kind

[4] On the facts of Edge Tools & Equipment Ltd v Greatstar Europe Ltd [2018] EWHC 170 (QB) at 65 it was said that inaction over a 10-month period would have sufficed to amount to an affirmation of the contract by conduct

In the context of the ISDA Master Agreement, it has been held by the English High Court that the methods of service for notices and other communications are mandatory and the only means of effective service[5]. This means that any potential solutions to the practical difficulties in serving notices arising from office and other closures as a result of COVID-19 that rely on non-contractual methods of service, for example e-mail (which is expressly excluded as a method of service for notices of default under the ISDA Master Agreements) may be open to challenges. As witnessed during the Lehman crisis, issues surrounding whether a notice has been effectively served and the date of such service can quickly escalate into disputes either about the effectiveness of the termination, or about the correct day for subsequent valuations.

It is therefore paramount to check any information regarding addressees and addresses, as well as the specified method of delivery and date of effectiveness, provided for in the contract for notices of the particular kind in question. The golden rule in normal circumstances is to follow the contract to the letter, and to keep a solid evidentiary record.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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[5] Greenclose Ltd v National Westminster Bank Plc [2014] EWHC 1156 (Ch), 128