HERBERT SMITH FREEHILLS

COVID-19: PRESSURE POINTS: IS A TEMPORARY SUSPENSION OF BUSINESS DUE TO COVID-19 AN EVENT OF DEFAULT? (GLOBAL)

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Legal Briefings – By **Amanda Teoh**

In secured lending transactions, it is common to include a trigger whereby an event of default will occur if a borrower "suspends or ceases to carry on (or threatens to suspend or cease to carry on) all or a material part of its business". This is consistent with the Loan Market Association (LMA) facility documentation.

Some variations on the usual formulation include: (i) a specific timeframe regarding the length of the suspension, (ii) a qualifier that such cessation or suspension would have a material adverse effect on the borrower's ability to perform its obligations under the finance documents, and (iii) a qualifier that an event of default will only occur if such cessation or suspension is "voluntary".

Following the declaration by the World Health Organization on 11 March 2020 recognising the coronavirus (COVID-19) outbreak as a pandemic, governments around the world have moved to close borders, restrict movement and impose mandatory closures of certain "non-essential" businesses.

This briefing looks at whether the cessation or suspension of business, as a temporary measure in response to COVID-19, could trigger a loan event of default.

While there has not been any case law directly on point, the meaning of the term "suspension of business" has been considered by the English courts to require something more than the cessation of trading on a seasonal basis or the suspension of business as a temporary measure to allow a trade recession to pass.[1] In addition, if it can be shown that there was no intention to abandon the business, "either wilfully or simply due to inability to carry on trading for other reasons", then it is less likely that a cessation or suspension of business has occurred.[2]

While the principles set out in the case law offer some guidance, whether a temporary suspension of business in the current context could trigger an event of default will ultimately depend on the particular wording in the relevant contract.

Where there is a contractually agreed time period by reference to which a suspension of business can be measured (for example, a suspension of business for more than 21 days), it is clear that if a company ceases all business for a period longer than such time period, an event of default will be triggered.

If a company has suspended some, but not all, of its business, whether an event of default has occurred will depend on whether such cessation is in respect of a "material part" of the business. While it might seem counterintuitive to some, the courts have resisted a formulation where materiality is measured by reference to a percentage or proportion of the business.[3] In *Decura v UBS*, the UK High Court held that a "material" part of a business is one that is "significant or substantial". In that case, it should be noted that the court did not have to consider whether the part of the business which was alleged to have been suspended was a "material" part of the business or not, because it found that there was no cessation of any part of the business – only a reduction or "substantial cutting back" of the number of products on offer.[4]

If an event of default is qualified by a requirement that a suspension of business has a "material adverse effect" (MAE) on the borrower's ability to perform its contractual obligations, whether there is an MAE will be a matter of judicial interpretation and a question of fact. If there is a significant impact on the borrower's ability to pay, this will likely satisfy the test of an MAE since failure to pay is always an independent event of default in any case.[5] For example, it was sufficient to trigger an MAE where a borrower's assets had been frozen by court order.[6] Conversely, where the suspension of business does not impact the borrower's ability to service debt repayments, it is unlikely this would constitute an MAE unless there are other contractual obligations which may be impaired.

Where an event of default is only triggered upon a "voluntary" suspension of business, it could be argued that the temporary cessation of business due to COVID-19 is a direct response to government regulations and therefore outside the scope of such provision.

Looking at some of the industry responses to the management of the COVID-19 outbreak by governments, undoubtedly one of the most affected sectors has been aviation. Some airlines have responded by reducing flight capacity by up to 75 to 95%, grounding a majority of or all of their fleets, cancelling international and domestic flights for a set period, shutting down airport lounges on a temporary basis, freezing loyalty programmes for a year or standing down a substantial number of staff.[7] At the same time, despite the travel bans and restrictions on international flights imposed,[8] airlines may very well be continuing to comply with contractual obligations, maintaining all licenses and authorisations to operate, holding airport slots, taking forward flight bookings in anticipation of the lifting of border controls, and generally continuing to trade albeit with a reduced number of flights or routes.

In addition, following government directives to close certain types of businesses (including bars, gyms and entertainment venues),[9] some retail businesses have made the pre-emptive decision to temporarily close all or a majority of their physical premises due to public health risks and reduced demand.[10] Where retailers continue to fulfil payment obligations to landlords and suppliers, and continue to pay employee wages, it could be argued that such temporary closures for a specified four to six-week period would not constitute a "cessation" of business, particularly if products continue to be sold through online channels.

Given the LMA wording for the "cessation of business" event of default provision includes where a company "*threatens*" to suspend or cease to carry on its business, and the varying permutations that may be reflected in a specific contract, it would be prudent for borrowers to check their facility agreements when contemplating COVID-19 related measures and to consider the impact, if any, those measures may have on their financing arrangements.

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1. In the context of insolvency cases, see Re Tomlin Patent Horse Shoe Co Ltd (1886) 55 LT 314 and Re Middlesborough Assembly Rooms Co (1880) 14 Ch D 104, CA. ("Re Middlesborough") as referred to in paragraph [14.36] of Bailey and Groves: Corporate Insolvency Law and Practice (5th Ed. 2017).

2. Re Middlesborough (1880) 14 Ch D 104, CA.

3. Decura Im Investments LLP and others v UBS AG, London Branch [2015] EWHC 171 (Comm) ("Decura v UBS") at [40] (obiter).

4. Ibid at [39].

5. Wood, P., International Loans, Bonds, Guarantees, Legal Opinions, 2nd ed, 2007, at 4-008 as referred to in Grupo Hotelero Urvasco SA v Carey Value Added SL [2013] EWHC 1039 (Comm) at [319].

6. BNP Paribas SA and others v Yukos Oil Co [2005] EWHC 1321 (Ch).

7. See https://www.businessinsider.com/coronavirus-global-airlines-suspending-o... accessed on 30 March 2020.

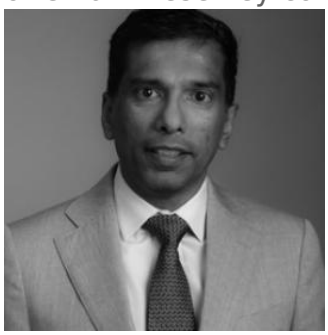
8. See eg, https://www.theguardian.com/travel/2020/mar/24/coronavirus-travel-update... accessed on 30 March 2020.

9. See eg, Coronavirus (Business Closure) (England) Regulations 2020.

10. See https://www.cnbc.com/2020/03/15/these-retailers-are-closing-stores-to-sl... accessed on 30 March 2020.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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