FINANCIAL MARKETS LAW COMMITTEE

COVID-19: Legal issues for financial markets

1. Introduction

1.1. The novel coronavirus (COVID-19) is having an immense, if rapidly evolving, impact on individuals, communities, and organizations. In addition to effects on the supply and demand, COVID-19 has jolted the financial markets. Since February 21, 2020, bond yields, oil, and equity prices have sharply fallen, and trillions of dollars, across almost all asset classes, have sought safety. In the United States, 10-year bond yields have tumbled below 0.5 percent and equity prices on major stock indices around the world have fallen.

1.2. Given the response by governments around the world to COVID-19, which has included steps such as closing down places of business and restricting the movement of people, several legal issues are likely to arise in the context of the financial markets.[1]

2. Relevant Issues of Legal Uncertainty

2.1. The outbreak of COVID-19 is having an increasing global impact, including ever-growing disruption. There are likely to be three broad categories of legal issues arising in this context:

a) increased risk of default and failures, leading to further insolvency;

b) increased litigation with regards to, *inter alia*, defaults and the performance of specific contracts; and

c) uncertainty around the operation of major operational disruption clauses.

Each of these are explored below.

Contractual issues

2.2. *Force majeure*: Many contracts will contain force majeure provisions that will release a party from liability for breaching its obligations (or failing to supply) to the extent that they are prevented from doing so for either specific reasons or something outside of their reasonable control. Sometimes, that release will only be granted if that party has implemented a responsible business continuity and disaster recovery plan, has provided notice and has also taken steps to mitigate the loss to the other party. Some customers may benefit from express rights not to pay for products or services not received and to terminate contracts if the force majeure event (e.g. Covid-19) has prevented performance for a defined period of time.

2.3. *Frustration, wrongful termination and wilful default*: There may be some businesses for which Covid-19 is not preventing performance (so they cannot rely on force majeure), but in

[1] The contents of this briefing note are for information purposes only. Nothing in this note constitutes legal advice. The FMLC is a research organisation which considers abstract issue. It is not in a position to offer legal advice on these (or any) questions as they may arise on the particular facts of a matter or in a specific context.

which it makes continued performance financially undesirable. In this case, they may try to argue that there has been a material adverse change – if the contract allows for that to trigger termination – or that the contract is frustrated and is therefore terminated immediately. There are a number of things to be aware of in attempting to rely on frustration, including that: the threshold for frustration is very high (the supplier's obligations must have become impossible, illegal or radically different from what was contemplated when the contract was made); some contracts will explicitly exclude rights of termination that are not expressly stated in them; arguing wrongly that a contract is frustrated brings with it the spectre of liability for wrongful termination; and this liability could be even higher if there is also uncapped liability for wilful default or wilful abandonment

2.4. *Material adverse change*: Whether or not a material adverse change ("**MAC**") clause gives a party to the contract the right to terminate in the event of the company's operations being affected by Covid-19 will depend on the wording of the relevant clause and the relevant circumstances. This will require a careful consideration of the clause and the specific facts which give rise to the MAC. As a general rule, it is harder to trigger the clause where the circumstances which give rise to the MAC are known at the time the contract is entered into.

2.5. *Applicable law:* In the UK courts, in civil and commercial matters, the rules on applicable law in contracts are set out by Regulation (EC) No 593/2008 on the law applicable to contractual obligations ("**Rome I**"). Under Rome I, effect is generally given to the parties' express choice of law. There are, however, limited exceptions which may, depending on the circumstances, apply. Article 9 of Rome I provides overriding mandatory provisions—i.e., provisions which may be regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract. Article 9(3) of Rome I permits effect to be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be, or have been, performed, in the event those provisions render the performance of the contract unlawful. It is possible that the restriction of movement or the imposition of unscheduled holidays could render a contract unlawful in the country in which it is to be performed.

2.6. In 2003, the FMLC published a research report considering the extent to which there are gaps in the legal measures that might be taken by public authorities and participants in the international wholesale financial markets in response to an event of major operational disruption (in that case, 9/11). The Report recommended that the terms of standard contracts used in the wholesale financial markets be reviewed to assess whether they will operate as intended in the event of market disruption and provided a checklist for such an exercise.[2]

Financing issues—Capital markets and loan financing

2.7. *Collateral demands under OTC Derivatives*: For a broad range of commercial reasons, corporates could be trading over-the-counter derivatives varying from foreign exchange, interest rates, commodities and equities through to freight forwards. The first casualties of any large market movements are often non-bank counterparties who are holding the wrong side of a trade (or a series of trades) in a particular market and are suddenly faced

[2] FMLC, *Report: Emergency Powers Legislation* (1 November 2003), available at: http://fmlc.org/emergency-powers-legislation-report/

with collateral demands they cannot meet. Over-the-counter derivatives often require that the party that is out of the money must provide collateral (usually cash or other liquid assets) to cover potential losses. A sudden and unexpected market movement, whether it be in equities, interest rates, foreign exchange or commodities prices, can impose a significant collateral liability on a counterparty on a daily basis based on the market value of their trading positions. Further collateral liabilities may accumulate for days or weeks if the relevant market continues to move against the counterparty. This can lead to cash flow problems for the affected counterparty and eventually the counterparty can reach a point where it can no longer meet collateral calls. A failure to meet a collateral demand can lead to the close-out (i.e. termination) of all outstanding derivatives transactions. Typically, following a formal demand, the counterparty has only a few days to post the collateral. If this is not done, the non-defaulting party will have the right to terminate all outstanding transactions, value the terminated transactions and require the defaulting party to pay the net amount calculated to be due. Whether a party will choose to terminate or not, and whether it will seek to rely on any other protections such as so-called "flawed assets," will depend upon a number of factors, including whether it is in or out of the money (i.e. would be receiving or making a payment on termination).

2.8. *Unscheduled holidays, payments and deliveries and notices*: Announcements in relevant financial centres for unscheduled holidays and market closures might affect settlements and valuations, and even trigger a disruption event, in which case an applicable fallback might be needed. The consequences may be different for different asset classes, including issuers or underwriters working on international offerings of securities, market participants entering into derivatives and agents or lenders on loan financings.

2.9. Such events may affect the performance of obligations under documentation such as the International Swaps and Derivatives Association, Inc. ("**ISDA**") or other market standard documentation. In order to assess the rights of the parties, typically two levels of inquiries are to be made: first, whether such an event (or any consequent non-performance) would constitute an event of default or a termination event under the relevant master agreement; and secondly, whether any particular disruption event which is already provided for in the transaction has been triggered, and if so, whether those provisions will take precedence over the termination provisions in the applicable master agreement.

2.10. It is likely that funders will require the provision of information under their (often wide) information undertakings. If the loan is not fully drawn, the parties will be examining whether the circumstances will result in a draw-stop, particularly if force majeure has been triggered under key contracts for the business or project. Ongoing analysis will be required to determine whether any event of default has been triggered. Credit agreements, particularly in construction financings, will include events of default for abandonment or suspension of construction works, for failure to achieve construction milestones or to progress the works, and, may also include a material adverse change clause.

Insurance

2.11. Many customers are exploring the possibility of filing business interruption insurance claims resulting from lost sales and interrupted supply arrangements. There are two key uncertainties in this context: (1) there is a possibility of disagreement about when the insurance payout has been triggered; and (2) disagreement between insurers and reinsurers about the aggregation of losses in order to maximise recovery.

2.12. While insurance coverage is relatively straightforward for interruptions tied to things like fires, floods, and other perils—classic contractual force majeure situations—a public health crisis falls under the much less clear category of a "contingent business interruption"—an event involving the insured's premises that interferes with production. As the 2003 SARS epidemic in Hong Kong demonstrated, a key issue in disease-related contingent interruptions is official government recognition of the situation such as classifying it as a "legally notifiable disease." Often, critical policy language limits coverage to cases in which those magic words are present and can spell the difference between coverage and exclusion.

2.13. As to the latter, the purpose of aggregation clauses in reinsurance contracts is to enable two or more separately covered losses to be treated as a single loss for deductible or other purposes when linked by a unifying factor. In cases where insurance companies authorise payment, reinsurance may not be available easily owing to variation in aggregation language.

Negative interest rates

2.14. Panic over the coronavirus and its threat to the global economy has made the prospect of negative rates in the U.S. very real. The Fed is at what economists call the "zero lower bound": The European Central Bank has been experimenting with modestly negative interest rates since June 2014, and the Bank of Japan has since January 2016. Under a negative rate system, investors pay borrowers to take their money. Benchmark interest rates (LIBOR, TIBOR, etc.) in transactions such as floating rate-linked loans and derivative transactions that refer to floating rates will become negative.

2.15. In the event of negative interest rates, parties to existing contracts may argue that their contracts no longer reflect their original intention. The FMLC's sister organisation, the Financial Law Board ("**FLB**"), attached to the Bank of Japan, has conducted in-depth analysis on the legal uncertainties arising in the context of negative interest rates.[3]

3. Proposed plan of action

3.1. Members to consider these issues and the desirability of publishing further research and/or best-practice guides.

[3] FLB, *Outline of the Approaches to Issues in Interpreting Contracts that Arise in Connection with the Introduction of a Negative Interest Rate* (26 February 2016), available at: http://www.flb.gr.jp/epage/edoc/publication44-e.pdf