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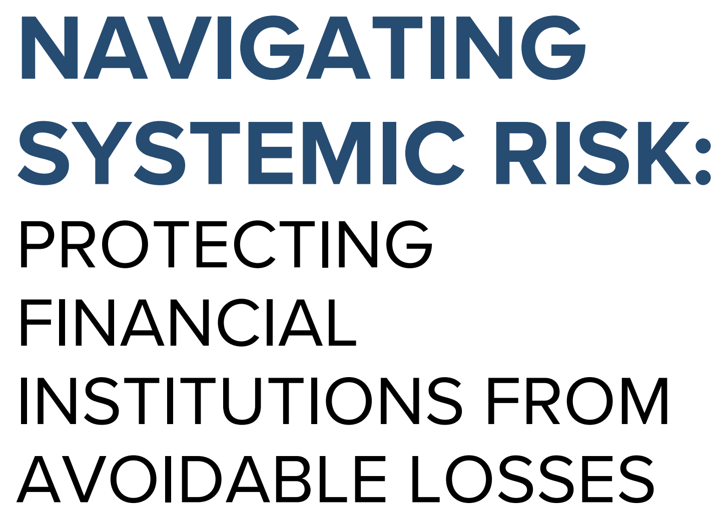

NAVIGATING SYSTEMIC RISK:

PROTECTING FINANCIAL INSTITUTIONS FROM AVOIDABLE LOSSES

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Navigating Systemic Risk

Protecting Financial Institutions from Avoidable Losses

2020

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FOREWORD: TRAVERSING THE MINEFIELD

BARNABAS REYNOLDS

COVID-19 has acted as an accelerator, bringing into play scenarios which were previously only contingencies and making contingencies of (and requiring planning for) situations which were previously barely imaginable. The debt build-up from the corporate sector, in many cases kept going by governmental life-support, means that non-performing loans are likely to explode once that support is removed. Numerous companies are at levels of debt that mean they cannot realistically take on much more. Preferred equity investments are possible, but provide less protection for the banks.

Yet it is not the risk to individual balance sheets arising from lending and other financial exposures that is the sole issue to be considered. The economic environment is also likely to create a variety of further risks for financial firms. Navigating the challenges and avoiding each of these risks will require enormous skill and, indeed, good fortune. Some of the challenges will be those we have seen before, such as deteriorating credit, liquidity concerns and volatile markets. Others will be new.

Unlike in previous environments, firms will need to take an overview of the situation in order to traverse it safely. The financial markets are highly interconnected, putting significant stress on individual firms. Since 1988, with the introduction of the international Basel Rules, the world's main regulators have been seeking, with ever-increasing degrees of sophistication, to tackle the risk of failure of individual banks. Detailed rules have been developed to cover the main financial risks that firms run—credit risk, market risk and operational risk. Complex calculations are made which ensure these risks are captured, at a firm level, and that the firm issues sufficient equity and subordinated debt instruments to absorb foreseeable losses that might arise were those risks to crystallize. Additional rules have also been put in place to ensure collateral is appropriately valued and that firms hold sufficient liquid assets to be able to continue operating during times of market stress.

These measures focus predominantly on banks, albeit in Europe they have also been applied to investment firms. In the US and elsewhere, complementary measures apply to broker-dealers and other financial market participants. More importantly still, the Basel Rules historically focused principally on so-called idiosyncratic risks. Since the financial crisis of 2007–8, there has been a renewed focus on the additional category of risk: systemic risk. This involves risk to the entire system, which arises because of the interconnectedness of the markets and the possibility of contagion, where one portion of the market ceases to deal with another because of insufficient certainty when doing so. Such a situation arose during the last financial crisis when the overnight repo market, and liquidity outside that market, dried up due to fear of loss—raising the cost of credit and closing off the ability of many firms to obtain new credit at all. Systemic risk is addressed by ensuring each individual firm manages the risk it takes on from that source, through the imposition of appropriately calibrated individual capital charges provided for in the Basel Rules, and also by ensuring that institutions have additional

top-up, loss-absorbing capital to cater for less identifiable forms of risk that might arise from their daily dealings.

Normally, matters of systemic risk are managed by the legislators, regulators and supervisors, imposing capital (including top-up) requirements on market participants. However, given the levels of debt now being absorbed into the world economy, and the fact that there could be a cascade of defaults, firms need to be aware of and mitigate systemic risk themselves. They need to apply a sufficient understanding of that risk to navigate the potentially choppy waters ahead and ensure market jitters do not bring the market to a close, or precipitate a calamity. Any shortfall in real-time transparency of counterparty and market data, and any concern over systemic factors, needs to be considered and addressed.

In this publication, we explain many of the most important issues that bank and broker-dealer management should now be contemplating as they seek to navigate the new reality and work to serve the interests of their many constituents, ranging from clients to shareholders to regulators.

London, 8 July 2020

EXECUTIVE SUMMARY

Systemic risk arises in a number of forms. There is no overarching solution to identifying or managing such risk. It was clear in the 2007–8 financial crisis that a cascade of (ultimately interconnected) occurrences caused market turmoil. But each occurrence was, at the time, unpredicted—from the effects of sub-prime debt arising from California, Florida, Nevada and other US states, to the undercapitalization of banks, to the lack of accountability of senior management and the dispersal of responsibility, to inappropriate compensation schemes which failed to address the risks accruing, to the lack of sophistication of credit ratings, a lack of transparency and so on. These matters have been extensively considered and addressed by subsequent regulatory interventions. Indeed, in some cases the fixes have gone too far and measures have duplicated each other, or worse, contradicted each other, in endeavoring to prevent recurrence. There is a need now to take stock and consider how to remove unnecessary red tape.

However, addressing systemic risk is not so simple. It has not been, and cannot be, captured in a specific set of rules. Instead, each of the forms it might take needs to be considered individually and in sufficient detail, and potential new forms need to be identified and mitigated. This publication assesses some of those areas which arise as a result of COVID-19 and explains how they might be monitored and addressed. We address the following topics:

1. *Crisis management*. We consider the criticality of strong governance and how to ensure the appropriate *fora* operate to ensure that issues are being addressed by teams with a broad enough perspective to identify and resolve problems without creating new ones. We also discuss the complexities of operating within the global regulatory environment and the importance of a holistic approach to the requirements of the different regulators.
2. *Effective use of capital*. We explain the impact of the crisis on capital levels and bonus payments. We consider the pressures on banks created by an economic environment in which governments and regulators are encouraging them to continue lending to provide liquidity and support to businesses, notwithstanding the resulting decline in capital levels as risk increases.
3. *Anti-trust and State aid*. We consider the opportunities that arise when institutions contemplate the use of some form of State aid, particularly in Europe. We also address the ways in which the current unprecedented situation might allow companies to collaborate more easily with their competition, although noting that, even with the best of intentions, the need for care remains and possible future concerns may arise. We summarize the likely approval environment for major financial institution mergers and conclude that it is likely little will change from historical practice.
4. *Litigation risk*. We examine the key types of disputes that have arisen so far out of the pandemic, including questions around the enforceability of contracts and issues relating to standard market-pricing functions. We also discuss what the pandemic may yet bring from a litigation perspective, including bankruptcies,

increased whistleblower claims, the uncovering of fraud as rogue employees work remotely, event-driven securities litigation and backlogs in court timetables.

5. *The replacement of LIBOR*. The transition from LIBOR posed significant challenges to financial institutions even before the COVID-19 pandemic. We explain some of the legal issues banks faced before the current challenge and note that these have not changed in the new environment. We urge management teams to continue and indeed enhance their focus on ensuring that the transition from LIBOR is effected in as seamless a way as possible.
6. *Conflict issues facing management*. Conflicts are inherent in modern financial institutions and managing them appropriately is a core competence of bank management. As the team note, conflict issues will almost certainly be exacerbated during the pandemic and the dangerous economic situation which will inevitably follow.
7. *Financial crime*. We address some practical ways of effectively managing risks of financial crime, which are heightened during periods of disruption and economic uncertainty. While regulators have shown a willingness to adopt some flexibility in challenging times, they are clear that financial institutions must continue to satisfy their financial crime risk obligations. We also consider how institutions can best prepare for other periods of significant disruption in the future.
8. *Credit risk and the likely possibility of default (1)*. We deal with the process and risks associated with individual and fund clients defaulting and the associated foreclosure and margin call processes that follow. We focus on the importance of banks having a clear understanding of the relevant rules and a well-defined process with good documentation to manage defaults smoothly, avoiding future issues.
9. *Credit risk and the likely possibility of default (2)*. We provide an overview of the issues arising from the “covenant lite” lending environment of recent years. We discuss the concerns and issues that will most certainly arise, but also consider potential opportunities.
10. *Credit risk and the likely possibility of default (3)*. We discuss the default process in both the US and UK and the important tools available to creditors.

We very much hope you find the information contained in this publication of interest and use as you manage through this crisis, and, of course, all of our Partners stand ready to provide help and guidance.

I. HOW BANK MANAGEMENT CAN BEST NAVIGATE SYSTEMIC RISK

SIMON DODDS

Although the COVID-19 emergency has not, to date, grown into a full-scale banking crisis, it may yet become so as the ramifications of the pandemic on the economy reveal themselves. The impact of COVID-19 on financial institutions is already, and will remain, significant. For example, there are signs of pressure on revenues and a pickup in loan loss provisions. The banking sector is in better shape to weather the storm than it was during the financial crisis of 2007–08, since the subsequent reforms to capital, liquidity and other areas make for a more robust financial system and reduce the risk of a systemic banking crisis. These reforms do not remove the risk altogether, and nor do they mean that individual financial institutions will not suffer severe and potentially existential challenges. It is clear that the COVID-19 crisis will inflict substantial pressure on all financial institutions; not just their financial and capital position, but also their organizational structures, personnel and culture.

Navigating through the COVID-19 crisis requires skillful leadership over a protracted period. Financial institutions, like numerous other businesses, already have taken steps to deal with the initial impact of the crisis. For example, many staff have been working at home for several weeks; some essential staff, such as traders, have remained in, or have now returned to, the office; risk management will be in defensive mode and monitored even more closely than usual. A key challenge for financial institutions of all types, irrespective of location, is the likely prolonged nature of the COVID-19 crisis. Notwithstanding recent steps to relax the rigor of lock-down, there is little information as to when society will revert to normalcy, however that may yet be defined. Banks will need to adopt crisis management techniques that will be workable over many months and that will allow the safe operation of business in very uncertain times. More strategically, financial institutions will need to consider whether existing strategies remain fully tenable in the current environment and in whatever new normal that may emerge from the COVID-19 crisis.

Outlined below are six key areas which senior management within banks and other financial institutions will need to keep front of mind in order to steer an effective route through the current crisis and beyond. In most instances, these recommended considerations are not exclusive to banking, but given the vital function of financial services to the economy as a whole, adherence, or otherwise, to these recommendations will have ramifications far beyond the individual institution in question.

Business Strategy

Across the financial sector and beyond, boards of directors and executives are considering how best to run their businesses during this unprecedented period of crisis and uncertainty. A key priority for the financial sector, in the near term, is to determine how best to manage a company's trading book. Volatile markets create attractive

opportunities, but bring with them risk and uncertainty. Assessing the right risk/reward balance is critical. Handling clients will raise recurrent problems. As the impact of the COVID-19 crisis flows through the economy, covenant breaches and defaults and, with them, loan losses will multiply. Depending on the financial institution's specific areas of business, government exhortations to grant forbearance to existing customers and to continue lending to small businesses, will pose complex questions for management.

As time passes, questions may be raised about whether an individual bank's pre-crisis strategy remains viable in the crisis and post-crisis environment. Notwithstanding strengthened capital positions, revenues will be sharply reduced in the short-term, and it is far from certain how quickly they will rebound. Existing business lines, sectors and geographies may look far less attractive as the crisis plays out. Regulators are asking for financial institutions to re-work their business plans and financial and capital projections. A shock of the magnitude of the COVID-19 pandemic creates business opportunity too, supporting the companies that emerge from the crisis in a strong position along with a restructuring of other companies. It is possible that a financial institution may need to restore its own financial situation, although a capital raising is difficult until markets stabilize. In the more extreme circumstances, seeking aid from the government may be necessary, although this raises its own challenges.

Organizational Structures and Corporate Governance

The strength and adaptability of organizational structures will be tested throughout the pandemic, and their resilience and effectiveness will play a key role in helping financial institutions navigate the COVID-19 crisis. Well run financial firms, like any company, should already be operating with a transparent corporate structure, with clear board assignments and with entities and committees operating within established remits and terms of reference. There should be clear reporting lines and responsibilities for internal functions. Effective processes should be in place for making decisions and resolving disagreements and operational overlap; decision-making processes should be understood by internal stakeholders. The quality and ease of interpersonal relationships at all levels of the institution become critical, especially those between executive management and the board.

At a time of crisis, the robustness of the existing corporate governance comes under pressure. It will need modification as the crisis develops. In the first instance, a series of special committees will often be created to help manage developments and provide a central focus for decision making and information exchange. At the apex, there is likely to be a group of the most senior managers in the organization meeting on a daily basis. In current circumstances, this meeting is most likely to take place virtually. The composition of this group may vary from institution to institution, but will include business heads, as well as the heads of certain key central functions, such as Risk, Legal and HR. Other functions may be involved depending on the topics of focus. Similar *fora* will likely be established in business divisions and subsidiaries.

Crisis managers will rely heavily on the quality and quantity of information they receive. This is, of course, core to classic risk management. In the first instance, senior management needs critical information about their own organization: its liquidity and

capital levels and its open trading positions, for example. It also needs a real-time understanding of credit and other exposures to counterparties, borrowers and the like, and an understanding of the creditworthiness of those counterparties and borrowers is increasingly important as the impact of the crisis is likely to spawn a wave of defaults. Decision-making will be compromised without access to sufficient, good quality data.

Regulation

For more global institutions, the multiplicity of regulators that they have to deal with in different countries, and sometimes (for example, the US) within the same country, adds complexity to the management of their regulatory relationships. Differences between international regulators can stem from the substance of their laws, regulations and techniques of legal reasoning; their regulatory style; and cultural norms. Frictions may exist and misunderstandings may occur between the home and local offices of financial institutions, and between home and host regulators. These challenges can increase during times of crisis when the ideal of cooperation for the benefit of the whole institution and the system may give way to an understandable imperative to protect local interests. Navigating the competing demands of regulators, at a time of potential systemic risk, represents a significant challenge for any financial institution; to do so effectively requires considerable skill. It is essential to take a holistic approach to managing the problem, ensuring that there is appropriate sensitivity to the needs of each of the regulators involved. Ensuring appropriate and timely sharing of information, if permissible, is usually desirable.

Investors

Communication with investors is governed in most Western countries, to some extent, by disclosure requirements for publicly listed companies. Beyond those requirements, financial institutions will want to maintain a dialogue with large investors as they did prior to the onset of the current pandemic.

Leadership

Strong leadership, from the Chairman and Chief Executive Officer and from all members of the senior management team, will be a defining characteristic of financial institutions able to navigate the current crisis effectively. Leadership is essential to reassure all stakeholders—regulators, investors, staff and the public—that the organization can survive the storm engulfing it and emerge to prosper in the post-crisis world. Prerequisites of successful leaders at a time of crisis include an ability to project calmness under fire, both to internal and external stakeholders. Decisive decision-making is key, dependent as it is on the effectiveness of the organizational structures of the institution and the quality and quantity of available data. Clarity of messaging goes hand-in-hand with decisiveness. Stakeholders need to see a leadership team with strength and seriousness of purpose able to articulate their decisions and actions unambiguously.

Open and transparent communication to all stakeholders throughout the crisis is of paramount importance. Communication is a core responsibility of the senior leadership

team but needs to be driven, effectively and consistently, across the organization. Communication is central to reassuring stakeholders during a period of anxiety. There may be times when there is little of substance to report on, but communication remains key. The nature of communication will differ depending on the stakeholder. In the case of the financial institution's principle regulator, there should already exist an open relationship between firm and regulator. The regulator should have a full understanding of the financial institution and its operations, its strengths and weaknesses, and will have a view on the capability of the institution to withstand severe shocks. Regulators may make their own demands of the bank, as in the UK where the authorities have effectively required banks to withhold dividends and not to pay cash bonuses to senior staff during the COVID-19 crisis.

Staff

The financial institutions' staff represents a diverse stakeholder group with potentially different concerns based on role, financial circumstances, family situation, age and location. Many will have fears about job security and about their ability to pay the mortgage and other household bills. Maintaining morale and providing reassurance, while being transparent about the institutions' position and the potential for future job cuts, requires care. Key substantive questions for management include whether to participate in government-sponsored furlough programs.

Summary

Financial institutions, like other companies, face significant structural, procedural and operational challenges while navigating the impact of the COVID-19 pandemic. In addition, an increased potential for regulatory friction and the uncertainty created by market volatility further pressurizes the financial sector. When we then consider the central role which financial institutions play within the economy and add to this national governments' habitual reliance on the banking sector to support small and medium businesses during times of crisis, we can appreciate the vital importance of successfully navigating systemic risk.

Recommended actions for senior management navigating systemic risk:

- Review business plans, and amend financial and capital projections to reflect the altered governmental, regulatory and business opportunity contexts.
- Review, modify, and strengthen corporate structure and governance.
- Implement crisis and risk management procedures and structures.
- Prioritize relationships with regulators and take a holistic view when managing local/global regulatory frictions.
- Maintain investor relations.
- Provide strong, consistent leadership across all aspects of the business.
- Increase the flow and transparency of internal and external communications.
- Provide additional support for staff.

II. RESPONDING TO REGULATORY CAPITAL RELATIONS

SIMON DODDS, THOMAS DONEGAN, TIM BYRNE
AND LE-EL SINAI

Capital is a long-standing indicator of a bank's financial strength, with larger banks being required publicly to disclose detailed information about their levels of capital. In response to the economic crisis resulting from the COVID-19 pandemic, banking regulators around the globe have taken actions designed to mitigate some of the potential negative impacts on bank capital. Ongoing efforts will be required to ensure bank capital requirements match what is necessary to ensure safety and soundness of the system, while at the same time allowing the economy to grow. This is a discussion that will necessarily be in part between firms and their individual regulators, but also on a market-wide basis in light of the unfolding events, which will indicate the likelihood of mass defaults across particular sectors and the risk of contagion. Some of the analysis highlighted in this essay is necessarily technical, but the current COVID-19 context means that it is more important than ever that senior management in the financial sector are on top of the key concepts concerning capital regulations, and that they are actively engaged in helping to ensure that the rules are appropriately calibrated to revitalize the economy while preventing systemic risk from arising.

Background

Most banks, wherever located, must hold a certain amount of capital relative to both total assets and risk-weighted assets (RWA). Capital requirements in major jurisdictions are based on international standards adopted by the Basel Committee on Banking Supervision (Basel Committee), although implemented often with local modifications. As a bank's capital levels decline, the bank generally becomes subject to increasingly stringent regulatory and supervisory restrictions designed to preserve the financial health of the bank. In general, these restrictions limit the discretion of a bank to engage in certain activities or make certain capital distributions. Capital tends to be a lagging indicator of a bank's health, and supervisors will monitor other financial aspects of a bank's operations, including liquidity and asset quality.

Practical COVID-19-Related Impacts on Bank Capital

A bank's capital ratios may decline due to various developments, other than capital distributions. Several changes impacting capital are occurring, or are likely to occur, in the current crisis, including:

- **Increases in total assets resulting from actions of customers**. These can include draws on lines of credit, leading to an increase in the amount of loans on bank balance sheets. These have increased markedly since the onset of the COVID-19 crisis, and are likely to continue to do so. Another cause is the increased placement of deposits with banks, particularly the largest of banks, which occurred when the US Treasury markets deteriorated.

- **Increases in a bank's RWAs** due to declining asset quality as the performance of some corporates begins to decline, warranties and covenants are breached, loan defaults occur and some companies enter administration. The bank may be able to mitigate the pressure on RWA levels by taking collateral or requesting guarantees from counterparties, although this will depend on existing contractual arrangements and negotiating power. The bank can also seek to sell assets although this may be unattractive in a likely falling market. At the same time, banks face a counterbalancing pressure to continue lending to corporates that need funds and for the sake, more broadly, of the economy. Governments around the world have consistently seen banks as a key delivery mechanism for transferring cash support to companies, during this crisis. This has been particularly true of support for small- and medium-sized enterprises (SMEs), and banks have committed to do this. The UK's Bounce Back Loan Scheme, which provides loans of up of £50,000 and the US's Paycheck Protection Program, which generally provides forgivable loans to cover SMEs' employee compensation, are examples of how funding has been made available to SMEs through banks.

- **Write-offs of loans or other assets, which will reduce retained earnings and thereby reduce capital**. Write-offs will become an increasingly important issue over the next year or so as the economic effects of the COVID-19 pandemic grips the wider economy. Loan loss reserves of banks are already moving upwards and that trajectory is set to increase. Capital depletion through loan losses is a common cause of bank failures and the high level of non-performing loans after the 2007–08 financial crisis remains a destabilizing factor for the EU banking sector, with Italy as a particular concern.

Flexibility in Banks' Permitted Use of Capital Buffers

Bank capital requirements post the 2007–08 financial crisis generally consist of mandated minimum funds plus capital buffers. Capital buffers represent an additional layer of capital that is available to banks for use in times of stress (both individual, sectoral and systemic), but not during the normal course of business. The buffers are designed to reduce excessive exposures and enhance banks' resilience to weather storms. Across the globe, regulators, including in the UK, EU and US, have encouraged banks to use their capital and liquidity buffers to free up capital to enable lending to households and businesses affected by COVID-19. For example, in Q&As issued in April 2020, the UK prudential regulator, the Prudential Regulation Authority (PRA), reaffirmed its expectation that these buffers had been built up for the purpose of supporting the real economy.

Generally, when buffers are used and fall below certain levels, restrictions apply to the distribution of capital (dividends, share buybacks and discretionary bonus payments). However, banks have built up substantial levels of capital and liquidity in excess of regulatory minimums and buffers since the 2007–08 financial crisis. This, and the scale of the current crisis, has prompted regulators to encourage banks to use the buffers as part of their response to the pandemic. A bank is not compelled to use its buffers; it is for a bank to choose to do so as a business matter.

Some regulators have taken further steps relating to capital buffers to mitigate the impact of COVID-19. For example, in the EU and UK, the regulators have issued statements and guidance confirming that banks can use the buffers without any compliance breach, although they have simultaneously requested banks to refrain from making dividend distributions. In addition, the UK's Financial Policy Committee (FPC) has also reduced the UK countercyclical capital buffer from 1% to 0% of banks' exposures to UK borrowers, effective on March 9, 2020. The FPC expects the 0% rate to apply for at least 12 months, and any subsequent increase will not take effect until at least March 2022. Similarly, the PRA issued a decision to maintain the systemic risk buffer rates at the rate set in December 2019. The rates determine the amount of additional regulatory capital that must be held by "systemic risk buffer institutions." In scope firms are the so-called "ring-fenced bodies" (banks and large building societies) holding more than £25 billion in deposits and only those entities that have more than £175 billion in total assets are subject to the systemic risk buffer.

In the US, the banking regulators also cautioned banks to "continue to manage their capital actions and liquidity risk prudently."

Global systemically important banks (G-SIBs) are also subject to an additional buffer which varies by institutions based on a number of metrics. These metrics include several quantitative measures relating to size, interconnectedness, substitutability, complexity, cross-jurisdictional activity, and (in the US) reliance on short-term wholesale funding. The G-SIB surcharge, together with other prudential standards, is designed to mitigate the potential risk posed by a G-SIB to the financial system by increasing the resiliency of such firms and reducing the impact on financial stability should such a firm fail.

Banks must disclose information regarding their capital levels, including its calculation of the capital ratios for Common Equity Tier 1 (CET1), Tier 1, total capital and leverage. If a significant change occurs such that the most recent disclosure is no longer reflective of the financial institution's capital adequacy and risk profile, then a brief discussion of this change and its likely impact must be disclosed as soon as practicable. Bank disclosures about capital levels will be an important area for senior management in banking and financial services senior management to watch in the coming months.

Relaxation of Overall Capital Requirements

Regulators have taken swift and decisive steps in response to the pandemic, ranging from delaying the implementation of legislation, or bringing forward its application, to relaxing reporting and disclosure requirements. Such actions have often followed the measures adopted by the Basel Committee and other international standard setters. Key measures worth noting are the one-year deferral by the Basel Committee, from January 1, 2022 to January 1, 2023, of the implementation of Basel III outstanding standards, and the one-year deferral of the final two implementation phases of initial margin requirements for non-centrally cleared derivatives. This section briefly summarizes the most significant measures adopted and guidance provided by regulators in the UK, the EU and the US.

Capital Distributions

On May 7, 2020, the UK PRA announced that all Pillar 2A requirements were being set as a nominal amount instead of a percentage of total RWAs. This reduces the threshold at which firms are subject to maximum distributable amount (MDA) restrictions, as a share of a firm's RWAs in the capital stack if RWAs increase. This amendment affects all firms subject to the EU Capital Requirements Directive. 2021 MRELs (minimum requirement for own funds and eligible liabilities) will reflect this Pillar 2A change. Furthermore, firms that need to transition to a higher MREL (firms not currently subject to a leverage-based capital requirement but which subsequently become subject to one) will be given at least 36 months after that requirement takes effect to meet the higher MREL.

At the end of March 2020, the PRA requested that the largest UK banks suspend dividends and buybacks on ordinary shares until the end of 2020 and cancel payments of any outstanding 2019 dividends. The PRA, in line with the European Banking Authority's guidance, also confirmed its expectation that banks would not pay cash bonuses to senior staff and would adopt a prudent approach to paying variable remuneration.

The US federal banking regulators—the Board of Governors of the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC)—issued an interim final rule that took effect on March 20, 2020, to phase in gradually the restrictions on certain distributions that apply automatically if a bank's capital levels decline. The interim rule revises the definition of "eligible retained income," a significant change because distributions are limited based on the measure of eligible retained income. The interim rule addresses the concern that on a sudden drop in capital (due to COVID-19 circumstances), banks would significantly restrict their lending to preserve the ability to make distributions.

In a related action, the Fed issued an interim final rule that became effective on March 26, 2020, which gradually phases in the automatic restrictions on capital distributions associated with a firm's buffer requirements under the Fed's total loss-absorbing capacity (TLAC) rule. (TLAC consists of long-term debt and Tier 1 capital, and TLAC requirements apply to the largest banking organizations.) The interim final rule revises the definition of "eligible retained income" so that (like with the capital rules), if there are reductions in TLAC levels, the limitations on capital distributions apply in a more gradual manner rather than in a sudden and severe manner.

On June 25, 2020, the Fed released (i) the results of its supervisory stress tests for 2020; and (ii) aggregate, not bank-specific, results of a special "sensitivity analysis" conducted under a range of "plausible downside scenarios" related to the COVID-19 pandemic.[1] Significantly, for at least the third quarter of 2020, the Fed will, with respect to the banking organizations that were subject to these tests: (1) prohibit most forms of share repurchases; (2) cap the growth of dividends and impose a limit that does not

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[1] The sensitivity analysis included the 33 banking organizations that were subject to the 2020 supervisory stress tests.

exceed recent income; (3) require them to re-assess their capital needs and resubmit their capital plans "later this year"; and (4) conduct additional stress analyses, also "later this year," as data become available and as economic conditions evolve.

Taken together, the first three months of the COVID-19 pandemic have prompted significant regulatory interventions in how banks distribute capital. Overall, the interventions appear to limit capital distributions for many large banks, which may in turn impact the attractiveness of bank stock as investments, but preserve capital cushions to deal with economic shocks as a result of the COVID-19 pandemic.

Accounting and Expected Credit Losses

Accounting standards, including International Financial Reporting Standard 9 (IFRS 9) and the new US Generally Accepted Accounting Principles (GAAP) standards, require banks to make judgement calls on expected credit losses (ECLs), based on information available. Many regulators have recognized that in the current situation there is not much reasonable and forward-looking information available.

For its part, the European Commission has confirmed the guidance of numerous EU authorities that confirms that banks should continue to identify where borrowers might experience financial difficulties that could impact their capacity to repay their loans in the longer term, and that their assessment of a significant increase of credit risk should be based on the remaining lifetime of the assets. The guidance also confirms that it is unlikely that COVID-19 temporary relief measures, such as private or statutory moratoria, constitute substantial "modifications" under IFRS 9. The UK PRA sent a letter on June 4, 2020 to all banks confirming its earlier guidance and adding guidance on further payment deferrals and exiting payment deferrals.

Furthermore, the EU has amended the Capital Requirements Regulation (CRR) as well as to the Regulation amending the CRR, known as CRR2, through a further amending regulation, the EU COVID-19 CRR Regulation (also known as the CRR quick fix package). This Regulation, which has applied since June 27, 2020, extends, by two years, the transitional measures for the implementation of IFRS 9. EU banks are required to implement these revised IFRS 9 transitional arrangements available to them to reduce the impact of IFRS 9 ECL provisioning on their regulatory capital. In a statement published on June 30, 2020, the PRA confirmed that UK-regulated banks already applying the CRR transitional arrangements for IFRS 9 must implement the revised calculations. A bank contemplating ceasing to apply the IFRS 9 transitional measures must first obtain PRA approval to do so. The PRA is encouraging those banks to submit their requests by July 31, 2020, which requests must include a written explanation of the basis on which senior management has satisfied itself of the continuing adequacy of the bank's financial resources.

In the US, the regulators issued an interim final rule, effective March 31, 2020, allowing banks to mitigate the effects of the current expected credit loss (CECL) accounting standard on regulatory capital, partly through the use of transitional provisions. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) also provides banks optional, temporary relief from complying with CECL.

These measures protect banks from potentially significant adverse capital impacts arising from the idiosyncratic nature of near-term modifications or losses resulting from the economic conditions caused by the COVID-19 pandemic.

Standardized Approach for Calculating the Exposure Amount of Derivative Contracts

On March 31, 2020, the Fed, the OCC and the FDIC published a notification that authorizes banking entities to adopt the standardized approach for counterparty credit risk (SA-CCR) one quarter early. SA-CCR is a new, more risk-sensitive, methodology for calculating the exposure amount of derivative contracts under the capital rules and became effective on April 1, 2020. The notification permits banks to adopt this approach for the reporting period ended March 31, 2020. Early adoption is allowed on a best efforts basis. However, upon adoption, institutions must use the same methodology for all derivative contracts.

This action allows US banks to apply sooner more accurate and favorable risk-measuring methodologies under the capital rules.

Delay of and Changes to Initial Margin Requirements

Following the Basel Committee's announcement of the deferral of initial margin requirements, the European Supervisory Authorities submitted draft revisions to the EU laws to the European Commission on May 4, 2020. The revisions would mean a one-year extension for entities with an aggregate average notional amount (AANA) of non-centrally cleared derivatives greater than €8 billion but below €50 billion until September 1, 2022, and a one-year extension for entities whose AANA of non-centrally cleared derivatives exceeds €50 billion until September 1, 2021. The extension would allow firms to concentrate their efforts now on supporting the real economy by giving firms more time to implement the necessary changes.

In the US, the Fed, the FDIC, the OCC, the Federal Housing Finance Agency and the Farm Credit Administration finalized amendments to their swap margin rule on June 25, 2020. Under the finalized rule, distinct corporate entities that are part of the same banking organization generally will no longer be required to hold a specific amount of initial margin for uncleared swaps with each other ("inter-affiliate swaps"). However, inter-affiliate swaps will remain subject to variation margin requirements. It should be noted that inter-affiliate swaps are subject to the requirements of section 23A and 23B of the Federal Reserve Act and the Fed's Regulation W.

These EU and US regulatory actions provide banks in such jurisdictions with relief from potentially burdensome margin requirements. In addition, the US swap margin rule is meant to facilitate the implementation of prudent risk management strategies at banks and other entities with significant swap activities.

Supplementary Leverage Ratio

CRR2 includes a discretion to disallow the exclusion of central bank debt from leverage ratio, which would be effective from June 28, 2021. The EU COVID-19 CRR Regulation

changes this to be a one-off assessment at the point of draw down. In line with the Basel Committee, the EU COVID-19 CRR Regulation also delays, from January 1, 2022 to January 1, 2023, the leverage ratio buffer requirement for G-SIBs (introduced by CRR2 in Europe).

In the UK, the PRA has made available a modification by consent of the calculation of the total exposure measure of the leverage ratio. Firms that apply for and obtain the modification will be required to calculate their exposure value of regular way purchases and sales awaiting settlement according to the incoming provisions of CRR2, effective June 28, 2021. The PRA is allowing firms to adopt these specific changes in advance of the application date.

In the US, as conditions deteriorated in the Treasury markets, financial institutions received significant inflows of customer deposits, which increased banks' total assets in March and April 2020. On April 1, 2020, the Fed issued another interim final rule, effective April 14, 2020, allowing bank holding companies, on a temporary basis until March 31, 2021, to exclude cash held with Federal Reserve banks and US Treasury securities from total assets for the purpose of the supplementary leverage ratio (SLR).

The SLR requirement applies to large financial institutions (generally those with more than $250 billion in total consolidated assets), and the relief is available to bank holding companies, savings and loan holding companies and US intermediate holding companies of foreign banking organizations. Although the rule is effective April 14, 2020, for purposes of reporting the SLR as of June 30, 2020, bank holding companies, subject to the rule, must reflect the exclusion of Treasuries and deposits at Federal Reserve Banks from total leverage exposure as if the interim final rule had been in effect for the entire second quarter of 2020. The interim final rule does not impact the calculation of the Tier 1 leverage ratio of bank holding companies. In related actions, the OCC, the Fed and the FDIC issued an interim final rule effective June 1, 2020, that also temporarily allows insured depository institutions (*i.e.*, the bank subsidiaries of bank holding companies) to exclude cash held with Federal Reserve banks and US Treasury securities from total assets for the purpose of the SLR. However, a bank that makes such an election must have done so by July 1, 2020. The election must have disclosed the election publicly and must have requested approval from its primary regulator prior to making certain capital distributions.

Impact of Loan Modifications

As the credit quality of an asset deteriorates, there is generally an increase in capital required for that asset. On March 22, 2020, the Fed, the OCC and the FDIC and other financial regulators issued an Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus, as revised on April 7, 2020. The statement encourages lenders to work with borrowers experiencing difficulties resulting from the COVID-19 pandemic, including modifying loans as appropriate. Among other matters addressed, the Interagency Statement states that for one-to-four family residential mortgages that were prudently underwritten and were not past due or carried in nonaccrual status at the time they were modified, the loans will not be considered restructured or modified for the purposes of the risk-

based capital rules. The regulatory agencies will not direct supervised institutions to categorize automatically all COVID-19-related loan modifications as troubled debt restructurings. Similarly, for loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral. Furthermore, the underlying exposure of a securitization will not be considered past due or to have contractually deferred payments under the relevant provisions of the capital rules due solely to such a payment deferral.

The US Interagency Statement mirrors the statements of the European Commission, European authorities and international bodies on the flexibility in the EU's current prudential requirements on the classification of non-performing loans (NPLs). The EU prudential rules do not require a bank automatically to consider an obligor in default when it calls on a guarantee and the temporary COVID-19 public and private *moratoria* schemes are not borrower-specific and should not lead to automatic reclassification of a loan as an NPL. Under the EU COVID-19 CRR Regulation, NPLs guaranteed or counter-guaranteed by the public sector receive the beneficial risk-weighting extended to export-credit. To qualify, the guarantees must follow state aid rules. This changes the minimum amount of capital that banks must hold for NPLs.

These actions have allowed banks to modify loans in response to the economic conditions caused by the COVID-19 pandemic without such modifications resulting in adverse impacts on financial institutions' balance sheets and capital positions.

Prudent Valuation

To mitigate the extreme procyclical effect of the current prudent valuation aggregation, the EU has amended the Regulatory Technical Standards on prudent valuation (Commission Delegated Regulation (EU) 2020/866 amending Delegated Regulation (EU) No 101/2016). The amendment increases the aggregation factor applicable to the core approach from 50% to 66% until December 31, 2020, with the aim of it applying for the June 30, 2020 COREP reporting.

Other Measures to Reduce the Capital Burden on Banks

The EU COVID-19 CRR Regulation includes the acceleration of two sets of changes to CRR2, bringing forward the implementation date of two measures that reduces the capital burden on banks. The first is the software asset deduction exemption. This is an exemption from the requirement to deduct certain software assets from CET1 capital; the provisions of which are effective 12 months after the related RTS come into effect. It is proposed that the exemption would be available earlier; from the date the RTS enter into force. The second is a measure lowering the capital cost for retail loans: CRR2 introduced lower risk weighting of loans granted by banks to pensioners or employees with a permanent contract against the unconditional transfer of part of the borrower's pension or salary, changes to the SME supporting factor and the new infrastructure supporting factor. The EU COVID-19 CRR Regulation implements this earlier than planned under CRR2, changing the application date from June 2021 to June 2020.

Summary

Overall, the uncertainty in economic and business conditions caused by COVID-19 is placing an increased focus on overall capital preservation while providing relief for certain limited impacts of the COVID-19 crisis. The new regulatory initiatives relating to capital will impact business planning, product offerings, disclosure requirements and investor relations considerations.

Recommended actions for bank management in responding to regulatory capital relations:

- Ensure that processes are in place to incorporate both capital relief measures and new regulatory requirements into various aspects of your business.

- Consider relevant aspects of your capital planning efforts in order to be able to adjust your businesses to evolving business conditions and regulatory expectations.

- Anticipate and prepare for detailed discussions with your regulators regarding capital position as the COVID-19 pandemic continues.

III. SUBSIDIZATION AND ANTI-TRUST CONCERNS
JAMES WEBBER AND DAVID HIGBEE

In Europe, authorities at EU and national level are loosening competition law substantially in response to the COVID-19 crisis. State aid, which is a pan-EU subsidization control regime, is the most obvious area. However, the anti-trust rules are weakening too.

In the United States, anti-trust regulators recognize that certain competitor collaborations or information exchanges may be necessary as a response to the spread of COVID-19. In response, regulators are expediting procedures to provide real-time guidance to businesses seeking to enter into such agreements. Nonetheless, these regulators continue to stand ready to pursue violations of the anti-trust laws.

We outline below relevant competition enforcement considerations across three key areas.

State Aid

The European Commission's (EC) COVID-19 State aid Temporary Framework , introduced on March 19, 2020 and amended three times since, is a major relaxation of the EU state aid rules. It enables the granting of additional forms of aid for the purpose of "remedying a serious disturbance in the economy of a Member State" and has a number of important implications for banks.

First, the State aid Temporary Framework facilitates the provision of liquidity to businesses through banks. It does this by confirming that where banks act as financial intermediaries, the support will be deemed to benefit only the end recipient and—so long as certain conditions are complied with—will not result in indirect aid to the bank.

Second, the State aid Temporary Framework can provide a temporary exception to the burden-sharing and resolution requirements of the 2013 Banking Communication and the Banking Recovery and Resolution Directive where, due to the COVID-19 outbreak, banks are granted:

- direct support in the form of direct cash grants to compensate for losses caused by COVID-19; or

- liquidity, recapitalization or impaired asset measures to rescue the bank itself.

While certain conditions on the availability of such aid continue to apply, this opportunity has not existed in Europe since the early days of the financial crisis. This is significant, since the temporary framework clearly reflects a political view that collaboration with the financial services sector is vital in navigating the current crisis. The framework may also have the effect of encouraging investment in struggling businesses or impaired assets.

Agreements with Competitors

In both Europe and the United States, there is much greater political willingness to favor collaborative efforts that help address the challenges of COVID-19.

In Europe, this is evident from the EC's recently published COVID-19 Temporary Framework for assessing antitrust issues in respect of cooperation measures to ensure the provision of essential products and services. This updates the EC's enforcement priorities during the crisis, as well as its assessment criteria for collaborations and its procedures for providing *ad hoc* written comfort in relation to such projects.

In the United States, the Antitrust Division of the US Department of Justice (DOJ) and the Federal Trade Commission (FTC) have published joint statements regarding the agencies' response to COVID-19 as well as several letters responding to requests for guidance from individual businesses (business review letters). These joint statements and business review letters outline the factors the DOJ and the FTC are likely to consider when evaluating agreements with competitors in response to COVID-19, as well as the procedures for seeking expedited review of any such agreements.

While the guidance from global regulators tends to focus on medical supplies and the health sector, banks will likely be eager to be part of these solutions wherever they have the expertise and capability to assist—such as in promoting financial stability and the provision of liquidity that underpins measures to support consumer welfare. There are likely numerous ways banks can help, some of which may involve collaborations with other financial institutions, particularly in respect of exchanging and sharing information over and above what they would normally do in the ordinary course.

The challenge for competition policy is to facilitate solutions to further these objectives while upholding the basic objectives of competition law. Banks should seek external legal advice before engaging in collaborative activity, or exchanging otherwise commercially sensitive information, with competitors that might usually fall foul of competition laws. This area is moving extremely fast and good external counsel will have other clients seeking to do the same thing.

Banks must be aware that documents and communications written now, however well intentioned, may later be disclosable to competition authorities when they are read not in the context of the COVID-19 crisis, but in a less sympathetic light. This was an unhappy feature of the financial crisis and a key learning point which should be front of mind as financial institutions navigate anti-trust regulation during the current crisis.

M&A

While the initial shock of the COVID-19 crisis may bring about an overall reduction in M&A activity, and associated bank financing, the economic downturn will invariably also present an opportunity for investors with access to capital to acquire struggling businesses or impaired assets at cut prices.

Where such acquisitions trigger merger control, the ordinary substantive rules and procedures continue to apply. This means that parties will typically have to notify and wait for clearance before completing—although derogations allowing clearances for urgent transactions are available and should be used more extensively. Parties should give careful consideration to how merger control can impact deal timelines and include appropriate safeguards in their transaction documents, as the current situation will likely lead to some delay in reviews and obtaining clearances. The EC has already encouraged merger parties to delay notifications where possible and to discuss timing of notifications and transactions with the case team. Similarly, the DOJ and FTC have requested extensions for ongoing merger reviews.

Once notified, will the regulators become more permissive of consolidation during the current crisis? We suspect the answer will be a nuanced "no." See *S&S Perspectives: How will COVID-19 measures impact substantive EU merger control review?*; *S&S Perspectives: Update—Antitrust and COVID-19*.

Both the EC and US regulators will be keen to stress that transactions that could result in competitive harm are as bad for consumers now as they ever were. They will be keen not to set a precedent that they may later have to live with. For example, with respect to "failing firm" arguments, the FTC recently published a blog post reiterating that they will not relax the evidentiary burden needed to establish the defense. Indeed regulators would likely prefer short term anticompetitive agreements between competitors as a response to the crisis to a merger that permanently removes competition.

That said, there will be borderline cases where parties might get away with a lighter review, or indeed avoid an in-depth review. With limited resources, competition authorities will have to prioritize the most difficult cases. There will also be a keenness to demonstrate the system is still working efficiently, which, under the current working conditions, may mean case teams.

Summary

Due largely to an unprecedented mass restriction of human movement across the globe, the economic impact of COVID-19 has been hugely detrimental across all sectors. Key industries such as manufacturing, retail, agriculture, technology and leisure have been severely disrupted, in many instances making loses from which it may take several years to recover. The financial services has in no way been exempt from the impact of this crisis, but, crucially, is relied upon by governments as a key player in managing the situation and in aiding our recovery from it. It is for this reason that financial services managers are required to play the dual role of not only protecting the best interests of their own company but also collaborating with key stakeholders such as regulators, governments and investors, in being part of the ongoing solution. This can only be done effectively by keeping a laser-like focus on the changing regulatory and market landscape and providing the leadership, adaptability and resourcefulness to maintain a company and workforce that is best able to navigate these challenging times.

Recommended actions for bank management in complying with current subsidization and anti-trust regulations:

- Understand how the European Commission's COVID-19 Temporary Framework for State aid affects your business both in terms of regulatory compliance and market opportunities.

- Maintain a close, transparent relationship with governmental and regulatory stakeholders to protect your interests and be open to new opportunities.

- Review your approach to collaborative partnerships and M&A activities in the light of the current context, but remember that any agreements written or deals signed during the crisis may be disclosable to competition authorities at a later date.

IV. LITIGATION OUTLOOK

ADAM HAKKI, DANIEL LAGUARDIA, GRACE LEE AND SUSANNA CHARLWOOD

As the COVID-19 crisis has spread across the world, we have witnessed an unprecedented disruption to businesses and a sudden and immediate dislocation of work forces on a mass scale. Both issues affect the type, amount and pacing of litigation involving financial institutions arising from the pandemic. As governments began to issue nationwide quarantine or shelter-in-place requirements in March 2020, the litigation issues that arose were immediate but also transient. Questions being asked include whether contracts are enforceable, whether standard operations, such as margin requirements based on market checks, should be executed as usual and how institutions should deal with intense government economic activism. However, although litigation has arisen around these issues and will likely multiply as more courts open up to new filings, many parties appear more open to negotiation and resolution than might have been expected. For example, the number of claims filed in the English Commercial courts dropped significantly during March, being at about a third of their normal weekly volume by the end of the month. However, this dip appears to have been short-lived with the number of claims filed in the Commercial and Chancery courts in each of the last three weeks of May exceeding numbers during the same periods in 2018 and 2019. In the US, published data suggests that in the federal courts—which have largely stayed open—litigation activity in existing cases slowed in March and early April, with new case filings down with respect to some subjects but up with respect to others where pre-litigation compromise or forbearance are less applicable—for example, securities class action litigation.

On this evidence, predictions of an increase in financial institution litigation resulting from COVID-19 that might rival the unprecedented wave of litigation stemming from the last financial crisis appear overstated, or at least premature. In 2007–8, financial crisis investor litigation fundamentally argued that the banks and broker-dealers contributed to the crisis through (allegedly undisclosed) lax loan underwriting practices and the layers of securitization that followed, and that they should therefore bear legal responsibility. No equivalent is evident with respect to COVID-19, which is a virus, not an asset class. Having said that, litigation risk exists for financial institutions in virtually any crisis, since they are the lenders, advisors and financial intermediaries dealing with trillions of dollars in transactions.

We discuss below the issues that arise regarding the enforceability of contracts in times of unforeseen crisis. The analysis below focuses primarily on US UK law, but of course other jurisdictions around the world will have their own formulations and their own requirements and tests for their own versions of the various doctrines and principles discussed. We also discuss below what may come as the pandemic stretches or recedes and the litigation landscape inevitably returns to something approaching "normal."

Disputes Arising Directly from the Pandemic

A. Questions Around Enforceability of Contracts

Widespread disruption to commercial activity has caused many businesses to face practical obstacles and/or economic difficulties in performing certain of their contractual obligations. As a result, companies and financial institutions may seek to determine whether they or their counterparties have a legal basis on which to excuse performance of those obligations.

While there is no one-size-fits-all answer to this question, and each contract will need to be assessed according to its specific provisions and jurisdictions, there are several general legal principles that should be considered when addressing performance difficulties posed by the current situation.

Force Majeure

Contractual force majeure clauses provide a narrow defense, excusing a party's obligation to perform in certain enumerated circumstances beyond the parties' control.[2] The construction of any particular force majeure clause will depend on the facts and circumstances of the situation, including the language of the clause and its meaning within the context of the broader contract, the extent to which the event prevents performance, the custom and practice in the particular industry and nuances of governing state law.

Nonetheless, in the US, some general principles are applied by courts in analyzing whether performance is excused by a claimed force majeure event.

- Force majeure clauses are interpreted narrowly, meaning that the type of event that prevents performance must be identified in the clause in order to excuse performance.[3]

- When a force majeure clause includes a "catchall" phrase in addition to an enumerated list of specific events that constitute force majeure, the catchall phrase generally is construed within the context of the preceding listed events or causes so as to include only events that are of the same general kind or character as the specified events mentioned in the clause.[4]

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2 *Stroud v. Forest Gate Dev. Corp.*, No. CIV.A. 20063-NC, 2004 WL 1087373, at *5 (Del. Ch. May 5, 2004).

3 *E.g.*, *Kel Kim Corp. v. Cent. Markets, Inc.*, 70 N.Y.2d 900, 902-03, 519 N.E.2d 295 (1987) ("Ordinarily, only if the force majeure clause specifically includes the event that actually prevents a party's performance will that party be excused."); Richard A. Lord, 30 Williston on Contracts § 77:31 (4th ed.) ("What types of events constitute force majeure depend on the specific language included in the clause itself.").

4 *E.g.*, *Kel Kim Corp.*, 70 N.Y.2d at 903 (catchall clause providing that force majeure events include listed events "or other similar causes beyond the control of such party" is subject to the principle of interpretation "that the general words are not to be given expansive meaning; they are confined to things of the same kind or nature as the particular matters mentioned"); *Stroud*, 2004 WL 1087373, at *5 (noting that the force majeure provision in the real estate development contract containing listed events followed by the phrase "or any other reason whatsoever beyond the control of [the

- The non-performing party has the burden to establish that a force majeure event occurred and excuses its performance.[5]

- Unless otherwise agreed in the contract, the occurrence of a force majeure event excuses performance by both parties.[6]

- In some jurisdictions, the non-performing party may be required to demonstrate its efforts to perform its contractual duties despite the occurrence of the claimed force majeure event.[7]

- Similarly, some jurisdictions require the non-performing party to demonstrate that the claimed force majeure event was unforeseeable at the time the parties entered into the contract.[8]

- In English law contracts, force majeure clauses operate in a broadly similar way.[9] It is worth noting, however, that force majeure clauses in English law contracts often expressly provide that:

- The triggering event need only hinder or delay performance.

- The affected party must show that it has taken all reasonable steps to mitigate the event's consequences.

- The party affected is entitled to an extension of time to perform or suspend performance of the obligation for the duration of the force majeure event. If the event continues over an extended period, the affected party may even be entitled to terminate the contract.

In all jurisdictions in the coming months and years, uncertainty over the applicability of contractual force majeure clauses potentially engaged by COVID-19 related disruption

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developer]" ordinarily would be "construed within the context established by the preceding listed causes," but inclusion of the word "whatsoever" suggested that "an especially narrow reading of the phrase was not intended").

5 *E.g.*, *Phillips Puerto Rico Core, Inc. v. Tradax Petroleum Ltd.*, 782 F.2d 314, 319 (2d Cir. 1985); *Aukema v. Chesapeake Appalachia, LLC*, 904 F. Supp. 2d 199 (N.D.N.Y. 2012) (applying New York law).

6 *E.g.*, *PT Kaltim Prima Coal v. AES Barbers Point, Inc.*, 180 F. Supp. 2d 475, 482 (S.D.N.Y. 2001) (applying New York law).

7 *E.g.*, *Phillips Puerto Rico Core, Inc.*, 782 F.2d at 319 ("the non-performing party must demonstrate its efforts to perform its contractual duties despite the occurrence of the event that it claims constituted force majeure."); *Watson Labs., Inc. v. Rhone-Poulenc Rorer, Inc.*, 178 F. Supp. 2d 1099, 1110 (C.D. Cal. 2001) (under California law, a party claiming performance was excused by an express force majeure provision must show "affirmatively that his failure to perform was proximately caused by a contingency within [the] terms [of the force majeure clause]; [and] that, in spite of skill, diligence and good faith on his part, performance became impossible or unreasonably expensive").

8 *E.g.*, *VICI Racing, LLC v. T-Mobile USA, Inc.*, 763 F.3d 273, 288 (3d Cir. 2014) (applying Delaware law); Watson Labs., 178 F. Supp. 2d at 1111-12 (applying California law).

9 *E.g.*, Pagnan SpA v Tradax Ocean Transportation SA [1987] 2 Lloyd's Rep. 42; *Tandrin Aviation Holdings Ltd v Aero Toy Store LLC* [2010] EWHC 40.

is likely to lead to increased litigation for the recovery of losses resulting from contractual non-performance.

Impossibility and Impracticability

Impossibility and impracticability are separate doctrines that excuse performance when an unanticipated event that could not have been foreseen or guarded against in the contract makes performance impossible or impracticable. A number of key points are worth noting:

- Some US courts and jurisdictions require actual objective impossibility, whereas others require impracticability, meaning that performance would require excessive and unreasonable cost—not simply that performance would be more costly than anticipated or would result in a loss.[10]

- Parties whose contractual performance has been temporarily or permanently prevented due to the various COVID-19 governmental shelter-in-place directives, shutdowns and travel bans may be able to rely on the doctrines of impossibility or impracticability if they can show they were not at fault, did not contribute to or in any way cause the impossibility, and that the governmental action was unforeseen at time of contracting.[11]

- The doctrines of impossibility and impracticability have been applied to excuse performance permanently or temporarily in contexts where governmental action has rendered performance permanently or temporarily impossible, but not where governmental action simply makes it more difficult or more costly to perform.[12]

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[10] *E.g.*, *Kel Kim Corp.*, 70 N.Y.2d at 902; *Habitat Tr. for Wildlife, Inc. v. City of Rancho Cucamonga*, 175 Cal. App. 4th 1306, 1336, 96 Cal. Rptr. 3d 813 (2009) ("A thing is impossible in legal contemplation when it is not practicable; and a thing is impracticable when it can only be done at an excessive and unreasonable cost. This does not mean that a party can avoid performance simply because it is more costly than anticipated or results in a loss."); *Maudlin v. Pac. Decision Scis. Corp.*, 137 Cal. App. 4th 1001, 1017, 40 Cal. Rptr. 3d 724 (2006) ("The obligation to perform is not excused or discharged by a temporary impossibility—it is merely suspended—unless the delayed performance becomes materially more burdensome or the temporary impossibility becomes permanent.").

[11] *E.g.*, *Inter-Am. Dev. Bank v. Nextg Telecom Ltd.*, 503 F. Supp. 2d 687, 696 (S.D.N.Y. 2007) ("A government order prohibiting performance under a contract may be grounds for claiming impossibility, but only where 'the fault of the party owing performance did not contribute to the order. . . . Resolution of the defense of impossibility requires an examination into the conduct of the party pleading the defense in order to determine the presence or absence of such fault. In all but the clearest cases this will involve issues of fact' that preclude summary judgment.").

[12] *E.g., Bush v. Protravel Int'l, Inc.*, 192 Misc. 2d 743, 750-54, 746 N.Y.S.2d 790, 795-97 (Civ. Ct. 2002) (holding that measures taken by the State and City governments, including the declaration of a State of Emergency in the wake of September 11, 2001, strongly supported the claim that performance had been rendered temporarily impossible for a period of time); *see also, e.g.*, *In re Martin Paint Stores*, 199 B.R. 258, 266 (Bankr. S.D.N.Y. 1996) ("[T]he entry of a judicial order that renders performance legally impossible excuses the party who must perform as long as he did not cause or fail to prevent the entry of the judicial order."), *aff'd sub nom. S. Blvd., Inc. v. Martin Paint Stores*, 207 B.R. 57 (S.D.N.Y. 1997); *Stasyszyn v. Sutton E. Assocs.*, 161 A.D.2d 269, 271, 555 N.Y.S.2d 297, 299 (1st Dep't 1990) ("absent an express contingency clause in the agreement allowing a party to escape performance under certain specified circumstances, compliance is required even where the economic distress is attributable to the imposition of governmental rules and regulations or the inability to secure financing").

- It is worth keeping in mind that these doctrines are applied narrowly and rarely succeed when the intervening hurdle merely results in greater difficulty or some financial expense or loss.[13]

Frustration of Purpose

The concept of frustration of purpose also discharges a party's duties to perform under a contract where an unforeseen event has occurred, which, in the context of the entire transaction, completely eliminates the underlying reasons for performing the contract, even though performance remains possible in a literal sense. However, there are limitations in practice worth bearing in mind:

- Frustration of purpose may have less applicability in the current circumstances because it excuses performance when a "virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party."[14] It is not enough that the transaction has become less profitable for the affected party or even that the party will sustain a loss.

- Because the frustration of purpose must be so substantial and the frustrating event must be one that could not have been foreseen or provided for by means of contractual safeguards, the doctrine is rarely found to apply in practice.

Under English law, the doctrine of frustration covers a range of circumstances similar in scope to the impossibility and frustration doctrines seen in US jurisdictions. Key points to note about the doctrine under English law are:

- Frustration will generally apply only where there is no force majeure clause in the contract that is applicable to the event in question.

- Where a frustrating event occurs, the contract automatically comes to an end and the parties are excused from their future obligations. However, parties will continue to be bound by obligations arising prior to the frustrating event.

- In some circumstances, amounts paid under the contract up to the time of the frustrating event can be recovered.

Additional Contractual Considerations

Parties evaluating their contractual obligations in light of the business disruptions caused by the COVID-19 crisis should also consider the following:

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[13] *E.g.*, *407 E. 61st Garage, Inc. v. Savoy Fifth Ave. Corp.*, 23 N.Y.2d 275, 281, 296 N.Y.S.2d 338, 344, 244 N.E.2d 37, 41 (1968); ("[W]here impossibility or difficulty of performance is occasioned only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy, performance of a contract is not excused.").

[14] *E.g.*, *Gander Mountain Co. v. Islip U-Slip LLC*, 923 F. Supp. 2d 351, 359 (N.D.N.Y. 2013), *aff'd*, 561 F. App'x 48 (2d Cir. 2014) (applying New York law); *Waegemann v. Montgomery Ward & Co.*, 713 F.2d 452 (9th Cir. 1983) (applying California law); *Chase Manhattan Bank v. Iridium Africa Corp.*, 474 F. Supp. 2d 613, 620 (D. Del. 2007) (applying Delaware law).

- Whether their contracts include Material Adverse Change clauses that may have been invoked (*see supra* Chapter IX).

- Whether their contracts include conditions precedent that have not been satisfied, whether non-satisfaction of those conditions precedent excuses performance temporarily or permanently, and/or whether satisfaction of certain conditions precedent can or should be waived.

- Whether their conduct or communication can be inadvertently interpreted as an intent to abandon contractual obligations to another party. The wrong messaging may be interpreted as (or at least argued to be) an anticipatory breach, and a contracting counterparty may suspend its own performance until it receives adequate assurances as to the other party's ability to satisfy its own obligations. Conversely, parties concerned that a counterparty may fail to perform at a crucial junction may seek assurances or performance from the counterparty and may initiate litigation if such assurances are found insufficient.

- Whether breaches by their contractual counterparties would excuse their own performance. In general, and in the absence of contrary contractual provisions, only material breaches permit converse non-performance.[15] A breach is material if it goes "to the root of the agreement between the parties."[16] Ultimately, whether or not a breach is material will be determined based on the specific facts of the case and by weighing multiple factors, including "the extent to which the injured party will be deprived of the benefit which he reasonably expected."[17]

- Similar principles apply in respect of English law contracts. A breach of contract may excuse the other party from performing their obligation if the relevant obligations are dependent. A breach may even entitle the other party to terminate the contract where the breach is of an essential term or is sufficiently serious that it deprives the innocent party of substantially all the benefit it would have received under the contract.

B. Market Disruption

The market volatility created by the COVID-19 pandemic, combined with the novel nature of the disruption and response, has also raised issues regarding standard market-pricing functions. For example, disputes have arisen as to whether volatility-driven margin calls should be honored as valid. Where securities are posted as

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15 *E.g.*, *Comedy Club, Inc. v. Improv W. Assocs.*, 553 F.3d 1277, 1289 & n.12 (9th Cir. 2009) (applying California law); *Medinol Ltd. v. Bos. Sci. Corp.*, 346 F. Supp. 2d 575, 618 (S.D.N.Y. 2004) ("As a general principle of contract law, a material breach excuses the other party's nonperformance.") (applying New York law).

16 *E.g.*, *Frank Felix Assocs., Ltd. v. Austin Drugs, Inc.*, 111 F.3d 284, 289 (2d Cir. 1997) ("A party's obligation to perform under a contract is only excused where the other party's breach of the contract is so substantial that it defeats the object of the parties in making the contract.") (applying New York law).

17 *E.g.*, *Barbagallo v. Marcum LLP*, 925 F. Supp. 2d 275, 287 (E.D.N.Y. 2013), *aff'd*, 552 F. App'x 102 (2d Cir. 2014), (citing Restatement (Second) of Contracts § 241 (1981) (listing circumstances that are significant for determining materiality of a breach)).

collateral for a loan or a derivative transaction, the governing contract often provides that the financial institution may demand additional funds or collateral if the value of the securities posted decrease below an established threshold. However, certain Real Estate Investment Trusts (REIT) subject to such a margin call during the COVID-19 crisis have argued that the issuance of a default notice and margin call in the context of the market dislocation resulting from the pandemic is inconsistent with the governing contract, reasonable business practices, and state and federal regulatory directives issued in connection with the current crisis and related business closures. Specifically, they have advanced the following arguments:

- First, that there was not a reliable market in light of the conditions brought about by the pandemic and that there was no "agreed" pricing source to establish the threshold breach in value.

- Second, counterparties have argued that margin calls and default notices are inconsistent with regulatory efforts to address the pandemic and the resulting mandatory business closures. For example, Executive Order No. 202.9 temporarily modified the New York State Banking Law to provide that "it shall be deemed unsafe and unsound business practice if, in response to the COVID-19 pandemic, any bank which is subject to the jurisdiction of the Department shall not grant a forbearance to any person or business who has a financial hardship as a result of the COVID-19 pandemic for a period of ninety days."[18] Counterparties have, with some squinting, argued that liquidating their securities would be an "unsafe and unsound business practice."

- Third, counterparties have argued that margin calls and default notices were inconsistent with statements issued by federal banking regulators which strongly encouraged financial institutions "to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the effects of COVID-19" and noted that the agencies "will not criticize financial institutions that mitigate credit risk through prudent actions consistent with safe and sound practices."[19]

- Lastly, in the early days of the pandemic, counterparties have argued that any attempt to value their collateral should await the government's efforts to mitigate the economic impact of the pandemic, including action by the Federal Reserve Bank's Federal Open Market Committee, which announced in March its plan to purchase Treasury and Agency mortgage-backed securities in an effort to support the financial markets, and action by Congress to increase the Federal Reserve's lending authority. Liquidating a counterparty's collateral before those

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[18] EO No. 202.0 (March 7, 2020), available at https://www.governor.ny.gov/sites/governor.ny.gov/files/atoms/files/EO_202.9.pdf.

[19] *See* "Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working With Customers Affected by the Coronavirus" issued by the FDIC, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the National Credit Union Administration, the Consumer Financial Protection Bureau, in consultation with state financial regulators, available at https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-39a.pdf.

policies have been implemented would undermine the government's efforts to stabilize the debt market.

All of these arguments are untested and, thus far, parties seem to have chosen to negotiate rather than litigate. However, we may see a change of approach as the dust starts to settle.

What the Pandemic May Yet Bring

A. Bankruptcies and Leveraged Lending

Bankruptcy

In the US, bankruptcy dockets will certainly swell as the build-up in leveraged positions and corporate debt since the last financial crisis is met head on by the unprecedented economic effects of the COVID-19 crisis. We are already beginning to see the increase in filings, and that is before government incentives and stimulus subside. In April, commercial Chapter 11 filings increased 26 percent from the year prior, with a total of 560. In May, Pier 1 and Specialty's Café and Bakery both announced Chapter 7 bankruptcy while three major retailers—Neiman Marcus, J.Crew and JCPenney—all filed for Chapter 11 bankruptcy protection.[20] Further, concerns for airlines and the travel industry continue, with some experts in the field believing that the airline industry may be forever altered. At the end of March, Arne Sorenson, Marriott's Chief Executive Officer, told employees that "the financial impact [of the pandemic] was worse than the post-Sept. 11 period and financial crisis combined." Meanwhile, the US Travel Industry Association has said the travel industry is in a "great depression."

In the UK, Parliament is currently considering the Corporate Insolvency and Governance Bill, which will introduce major reforms to the UK insolvency regime (some of which have in fact been slated since 2018).[21] While some of the changes are aimed at providing temporary assistance to businesses struggling with the economic impact of COVID-19, others will be permanent. The new measures include:

- An additional 20-business day moratorium on the commencement of proceedings and security enforcement similar to that available during administration.

- A presumption that directors did not worsen the financial position of their company or its creditors in the period between March 1, 2020 and 30 days after the bill enters into force, thus reducing the scope for wrongful trading claims.

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[20] *See* Sapna Maheshwari, *J.C. Penney, 118-Year-Old Department Store, Files for Bankruptcy*, NY TIMES (May 15, 2020), https://www.nytimes.com/2020/05/15/business/jc-penney-bankruptcy-coronavirus.html.

[21] For further discussion on this issue, *see* Shearman & Sterling Perspectives, *COVID-19 Changes Announced To UK Insolvency Law and For AGMS* (March 31, 2020), https://www.shearman.com/perspectives/2020/03/covid-19-changes-announced-to-uk-insolvency-law-and-on-agms?sc_lang=de-DE/.

- A ban in certain circumstances on the use of "*ipso facto*" clauses, which entitle suppliers of goods and services to terminate, vary or exercise any right under a contract due to its counterparty entering into an insolvency or restructuring process.

- Statutory demands will be void if issued, and winding-up petitions based on the debtor's inability to pay debts as a result of COVID-19 will be dismissed if presented, in the period from March 1, 2020 until 30 days after the bill enters into force.

- A new restructuring plan similar to existing schemes of arrangement but which allows "cram downs" of dissenting classes of creditor.

It is not yet clear when the new legislation will enter into force, but it is generally expected to do so at some point in the next few months. The new changes may significantly reduce the number of UK insolvency proceedings, at least in the short term. However, once the temporary measures expire, we may still see a significant surge in insolvencies.

Leveraged Lending

In the US, some have predicted for years that syndicated, leveraged lending—particularly in the "Term Loan B" space where buy-side investors extend credit in facilities arranged by financial institutions—would become a source of "investor" litigation against financial institutions akin to that seen in the credit crisis, at least once corporate bankruptcies begin to spike. A handful of such cases were pending at the start of the pandemic and, in one closely-watched case, a federal district court recently dismissed plaintiffs' claims against arrangers of a Term Loan B financing for a company that went bankrupt, rejecting their efforts to re-characterize the financing as a sale of securities governed by the securities laws, and likewise rejecting the notion that financing arrangers owed fiduciary-style duties.[22]

B. Increased Whistleblower Claims and *Qui Tam* Litigation

There is also evidence that whistleblowers are more active, even while working from home. In a keynote address for the Securities Enforcement Forum West 2020, Steven Peikin, co-director of the Securities and Exchange Commission's (SEC) Division of Enforcement in the US, remarked that the SEC has received approximately 4,000 referrals, tips and complaints of potential corporate misconduct from mid-March to mid-May, marking a 35% increase from this same time last year. Such increased activity will add to the number of accusations of fraud, both valid and invalid. Some of this increase may be temporary, arising from opportunity or a disrupted cultural moment, but the cultural distance provided by remote work may well render the increase in such reporting permanent.

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[22] *See Kirschner v. JPMorgan Chase Bank, N.A.*, No. 17-cv-6334 (PGG), 2020 WL 2614765, at *7-10, *14-15 (S.D.N.Y. May 22, 2020).

Additionally, given the extensive government aid programs implemented in response to the pandemic, many have predicted that *qui tam* litigation—cases where the government, or a whistleblower seeking to act in the name of the government, asserts that a party made false claims to the government in connection with a government contract program—may spike. This trend was seen in the context of mortgage crisis, for example.

C. New Compliance Issues Resulting from a Remote Workforce

The widespread shift to working from home across many sectors raises a series of compliance concerns. If everyone works from home, certain fraudulent behavior becomes easier, and other behavior becomes harder to cover. Thus, the dislocation of staff from their offices will both uncover rogue practices that required constant presence and access at an office to maintain, and lead to new practices that grow through the cracks of compliance. In the past, temporary dislocation has allowed firms to uncover rogue financial behavior. We expect the same thing to happen now. In addition, employers may face serious issues trying to police internal policies on data protection and confidentiality. Widespread remote working is likely to increase the risk of confidential company or client information being leaked. For instance, employees may not have access to confidential waste disposal at their homes, or may have little choice but to work and take calls within earshot of other members of an employee's household. Companies will need to consider how they can amend or adapt existing policies in the current climate in order to reduce the risk of widespread breaches. In the UK, remote working may similarly increase compliance risks around personal data and GDPR, where information is not stored or disposed of safely. The same is true for California, where enforcement of the newly effective California Consumer Protection Act is set to begin starting on July 1, 2020.

D. Revelation of Prior Misconduct That Cannot Be Concealed by a Remote Workforce

One can expect to see that issues around fraudulent business practices and rogue employees will increase as the economic downturn uncovers wrongdoing that might otherwise go unnoticed in better times. Fraudulent business practices, be they Ponzi schemes, trading schemes, kiting schemes or others, often fail when there is insufficient movement or growth in the market to cover the "hole" at the center of the scheme.

E. Event-Driven Securities Litigation and Securitization-Related Claims

Even before the COVID-19 pandemic, so-called "event-driven" securities litigation in the US had become a dominant form of securities litigation, albeit with mixed success for plaintiffs. In contrast to traditional securities litigation focused on alleged accounting frauds or business performance, this strand of securities class action litigation focuses on a particular corporate event or trauma—such as a regulatory fine for bribery, a failed drug approval or even an airplane crash—as a basis for shareholder recovery. One can conceptualize COVID-19 as such an "event," and some such cases have already been filed related to industries like travel and hospitality, but doing so successfully may prove challenging for plaintiffs. Among other things, it is hard to argue that any securities issuer (whether a corporate or financial institution)—or its financial institution

underwriters—should have had special advanced insight into the occurrence or effects of COVID-19, including especially shelter-in-place and shutdown orders not seen in the history of most modern industries. Additionally, proving that an alleged misrepresentation actually caused investor losses, as opposed to merely reflecting a market or sector decline, may prove similarly challenging. Confronted with such arguments in the last financial crisis, investor plaintiffs argued that the banks *caused* the crisis. There would not appear to be any such argument when it comes to COVID-19. That said, it remains to be seen what investor losses and disclosure-based claims might arise based on investments made *after* the impact of COVID-19 is better understood and companies have more information with which to calibrate their disclosures.

Mortgage and other asset-backed securities were the primary litigation battleground in the last financial crisis, with investors seeking to recoup securities purchase losses in class and individual actions as well as through demands that sellers repurchase the securitized loans. Here, again, the main artery running through such cases—claims of systemic loan underwriting failures by financial institutions—does not appear supported or a good fit for COVID-19-driven investment losses, but the possibility of such litigation remains.

F. Overwhelmed Dockets

Finally, concerns around overwhelmed dockets loom. US Courts will reopen to a backlog of reportedly thousands of stalled cases, and a flood of new filings that were not able to be filed with restrictions in place. The Federal courts asked Congress for additional funding to cope with the expected backlog to follow the reopening of courtrooms. While the courts have coped with the pandemic by leaning into a virtual dispute resolution environment, certain proceedings may require the physical courtroom.[23] In England, there is a concern that the expected surge in the number of disputes in the coming months may overwhelm the courts' capacity to deal with them. Former senior judges have called for contracting parties to afford each other "breathing space," and the UK Cabinet Office has issued "non-statutory guidance" urging contracting parties to act in a spirit of co-operation and achieve practical outcomes. Commercial parties will act in their own interests; if this means they need to litigate to protect their positions, then they will. However, the scope for delay due to the expected increased caseload may encourage would-be litigants to focus more on alternative dispute resolution processes, such as mediation.

Summary

Despite an unprecedented disruption to business including a mass dislocation of workforce and a fundamental shift of consumer priorities, so far the COVID-19 crisis has

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[23] *See, e.g.*, Sherri R. Carter, *Attorneys: Use New Attorney Portal to Sign Up For Court's New LACourtConnect Remote Courtroom Appearance*, LOS ANGELES COURT (June 2, 2020), http://www.lacourt.org/newsmedia/Uploads/1420206417214620NTA_LACourtConnect_FINAL.pdf (Los Angeles Superior Court will utilize a new program beginning June 22nd allowing for remote appearances) *Notice Regarding Press and Public Access to Court Hearings; Information on Observing Court Proceedings Held by Videoconference*, US DISTRICT COURT N.D. CAL., (Updated May 21, 2020) https://www.cand.uscourts.gov/notices/notice-regarding-press-and-public-access-to-court-hearings-april-3-2020/.

not generated the significant increase in litigation that was witnessed during the 2007–8 financial crash. It is too soon to tell whether this will change once the full financial impact of the crisis is known and all courts are fully functional, but the fact that this crisis has a public health, rather than financial, origin suggests to us that 2007–08 crash-level litigation—at least for banks—is unlikely. Nevertheless, any crisis increases the risk of litigation for financial institutions and managers should therefore not only be aware of, but closely monitor, relevant cases within the key areas highlighted above.

Recommended action for financial services management in respect of COVID-19 related litigation:

- Maintain an up-to-date knowledge of relevant case filings and outcomes in respect to key litigation areas that may affect your business.
- Review any potential vulnerabilities around the enforceability of contracts or market volatility.
- Review the litigation, compliance and enforcement implications of any major operational changes to your business, such as remote working.

V. THE CONTINUED PUSH FOR LIBOR TRANSITION

PATRICK CLANCY, BARNABAS REYNOLDS, THOMAS DONEGAN, JAMES DUNCAN AND MARK CHORAZAK

The LIBOR (interest rate) benchmark, which is intended to reflect the costs of banks' unsecured borrowing in the wholesale funding market, has been used by banks for decades. In light of evidence of the manipulation of the benchmark, the UK's Financial Conduct Authority (FCA) has decided that LIBOR should effectively be discontinued from the end of 2021. There are various international efforts that aim to address the transition from LIBOR. In the UK, the Working Group on Sterling Risk-Free Reference Rate is supporting the transition from sterling LIBOR while in the US, the Alternative Reference Rates Committee (ARRC) is supporting a transition from US dollar LIBOR.

Unless it is delayed, the transition from LIBOR at the end of 2021 is an event that gives rise to systemic risk that needs to be navigated against the backdrop of COVID-19. The FCA has stated that the timetable is unaffected by COVID-19.[24] The ARRC has also continued to push for the larger banks to transition as soon as possible. For the US medium-sized banks, there are discussions of a move to a synthetic rate, which would comprise the risk-free rate (RFR) plus a dynamic spread that more closely replicates LIBOR. Furthermore, the various market associations, including the International Swaps and Derivatives Association (ISDA) and the Loan Syndications and Trading Association (LSTA), have continued to publish, for their members, new model provisions that provide for fallback RFRs plus various forms of fixed spread, but not replicating LIBOR.[25]

What Is LIBOR and How Does It Work?

LIBOR seeks to reflect the cost of banks' unsecured borrowing in the wholesale funding market. It is used by banks in various ways, including in determining the interest payable by their borrowers. Much of a bank's funding outside the interbank or wholesale funding market is itself linked to LIBOR, so a common base for a bank's lending and funding is risk-reducing. Banks also enter into interest rate derivatives to manage LIBOR exposures and offload uncovered interest rate risk.

LIBOR is compiled from submissions from banks made to ICE Benchmark Administration Limited (IBA), based in London and supervised by the FCA. The transition to administration by IBA and FCA supervision in 2014 was the result of earlier issues with LIBOR, then administered by the British Bankers Association (BBA), arising in connection with the financial crisis, including reduced interbank lending and charges of manipulation. However, even the report and recommendations that led to the transition

[24] FCA, "Impact of the coronavirus on firms' LIBOR transition plans" (March 3, 2020) (stating that "[t]he central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet").

[25] The LSTA, as co-chair of ARRC Business Loans Working Group, has assisted in developing the LIBOR fallback language for US loans; LSTA News Release, LIBOR: FREE FALLBACKING, April 25, 2020. ISDA announced on April 15, 2020 the preliminary results of its consultation on pre-cessation fallbacks: ISDA press release, ISDA Announces Preliminary Results of Consultation on Pre-cessation Fallbacks for LIBOR, April 15, 2020.

from BBA administration and direct FCA oversight, known as the Wheatley Review, noted a case for "exploring alternative benchmarks that could be used in certain applications" and a "debate on the long-term future of LIBOR"—which the FCA subsequently decided should effectively be discontinued at the end of 2021.

UK and US central banks and regulators have determined that from this date, banks should switch their loan and derivatives documentation to use rates based on risk-free metrics, and not any estimate of inter-bank rates. For sterling, the RFR is SONIA, which is the rate for unsecured overnight sterling borrowing from financial institutions as reported to the Bank of England.[26] For US dollars, the RFR to be used is SOFR, which is based on the cost of overnight US dollar borrowing from the Federal Reserve against the provision of collateral in the form of US Treasuries.

The Systemic Risk Concern

Neither SONIA nor SOFR is intended to, nor does it, reflect the banks' true cost of term borrowing in the inter-bank market. In the UK, the SONIA rate covers overnight funding only. The SOFR rate in the US reflects secured overnight borrowings, meaning that the monies obtained are earmarked for the return of the security (*i.e.*, US Treasuries) and cannot be used to match the banks' term loans. The economic circumstances brought about by the COVID-19 pandemic highlight these issues. In times of financial stress, the RFRs can be expected to fall (as indeed they have done as a result of COVID-19), while the term funding rates for any stressed bank can be expected to rise.

So the issue arises that the RFRs are not genuine funding sources for the banks and cannot be of any real use to a lending financial institution. Bank lenders will need to hedge out their RFR-to-genuine-borrowing-costs risks in the derivative market. This will be bespoke (in the absence of a LIBOR rate to use) and costly. To the extent that banks do not hedge out these risks, they increase their exposure to market movements which result in a change in the difference between RFR and borrowing costs. The use of LIBOR as a lending measure meant that this risk, in relation to lending, did not need hedging, as it was – or was supposed to be – a genuine cost rate. So there will be a new risk to hedge out and a derivative market that will be ill-equipped to provide a standard hedge for it.

A bank could, of course, and will, add a spread to its RFR-based lending costs to cover the difference between the RFR and its own cost of funds, and a spread to cover the credit risk of the borrower. While these spreads are expected (currently) to be quoted as a single spread, they can be analyzed as made up of these two parts. The issue that arises is that the portion of the spread covering the difference between RFR and bank funding costs should be greater than necessary on account of the risk of variance in that difference over time since the bank will need to pass on that risk in the form of a higher spread. In essence, with LIBOR lending, that risk of variance was not borne by the bank as the rate charged to borrowers as LIBOR would go up commensurately with the increase in the cost of bank funding. So, ultimately, borrowing from banks should be

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[26] SONIA reflects borrowing unsecured overnight funds from other financial institutions: *See* BofE website on SONIA.

expected to get more expensive as we move to RFRs. In fact, it is precisely when a bank runs into trouble that the interest rates it receives from its borrowers, after adjusting for any borrower-specific margin or spread and pays to its funders, needs to match or be correlated. The potential mismatch or lack of correlation is a source of risk (currently unmanaged risk) which, when aggregated across the financial system, becomes a source of systemic risk to the market and to the banks' customers.

The economic disruption borne by the COVID-19 pandemic compounds issues with fixed spreads. Central bank rates are at historic lows in response to the crisis: in the UK, the Bank of England cut its base rate to 0.1% on March 19; the European Central Bank has left its key main refinancing operations rate at 0%; and in the US, the Federal Reserve set a Federal Funds Rate target of 0%-0.25% on March 16. Falling central bank rates increase the divergence between the rate at which a borrower may borrow from a bank if charged a fixed spread and that bank's cost of funding the relevant loan. This highlights the need for further thinking in determining the appropriate additional bank risk spread in light of today's economics.

More generally, the disruption caused by the COVID-19 pandemic is likely to make it challenging to transition to alternative rates in time for the end of 2021 deadline. A significant amount of work is still needed, including the amendment of legacy agreements based on LIBOR and the build-out of technology related enhancements by third-party-technology and operations vendors. The FCA has noted that some interim transition milestones will likely be affected by the pandemic, but has highlighted that the end of 2021 must remain the target date for the completion of the transition. In addition, the ARRC has recently issued a set of "recommended best practices"—some of which include 2020 calendar year deadlines—that confirm that institutions should operate on the assumption that LIBOR will indeed end as of December 31, 2021, regardless of the prevalence of the COVID-19 pandemic. Several market commentators have queried whether this present financial crisis is the right time to impose a nice-to-have, policy-driven change to lending markets with no clear economic rationale for the timetable, or whether it would be better to wait. Waiting would allow data to build up on the performance of alternative rates in different times of the economic cycle and provide more time for the market to adjust.

The UK Government has even acknowledged that there are some "tough legacy" contracts that simply lack a viable route to renegotiation or amendment. To address this predicament, the UK Government has recently announced its intent to bring forward legislation that would provide the FCA with "new regulatory powers" to manage the transition.[27] The legislation would authorize the FCA to enable the continued publication of LIBOR using a different and more robust methodology and inputs.[28] This LIBOR, which some have called "Legislative LIBOR," would apparently obviate the need to slog through amending these so-called "tough legacy" contracts, a term that the legislation

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[27] Rishi Sunak, Chancellor of the Exchequer, Written Statement – HCWS307, "Financial Services Regulation" (June 23, 2020).

[28] FCA, "Benchmark Regulation – proposed new powers" (June 23, 2020).

does not define. Put differently, because these contracts would still reference "LIBOR," no amendments are needed to reflect the transition to an alternative reference rate.

By contrast, the US legislative approach, led by the ARRC, has centered on legislation that would, "by operation of law," result in direct changes to contracts governed by New York law.[29] The legislation—the enactment of which is no certainty—would enable the functional amendment of contracts to reflect the statute's "recommended benchmark replacement" language. The diverging legislative approaches by the UK and US may raise more questions than answers and do not offer a complete "fix." Accordingly, institutions should continue with client communications strategies and continue taking other proactive steps related to the transition.

Ongoing Work Needed

The UK and US, as the hosts of the global financial market, need to address the systemic risk concern. Banks' interest rate payments for their wholesale funding—and certainty of funds—could be put at risk by a change to RFRs. A rethink of the deadline for transition may be appropriate given the circumstances. The Federal Reserve has already abandoned plans to require loans made under its COVID-19 "Main Street Lending Program" to be priced with SOFR rather than LIBOR, following a warning from the American Bankers Association that such an abrupt transition in the circumstances might deter businesses from making use of the program.

Work in determining an appropriate bank risk spread on lending benchmarks is ongoing and should continue. Organizations such as the Bank of England and ISDA are looking to calculate appropriate spreads. However, proposed spreads have generally been fixed spreads (see for example, the fixed spread that is used to calculate EONIA, the Euro OverNight Index Average, which expresses the weighted average of unsecured overnight interbank lending in the European Union and the European Free Trade Association). These may create issues, and have been difficult to come up with in a way that satisfies market participants. A variable spread on bank lending benchmarks may be the solution, but further work is needed in this area.

Solutions such as the US Dollar ICE Bank Yield Index, which replicates US dollar LIBOR through observable secondary market transactions and therefore sidesteps the problems with the original LIBOR, also require careful consideration.

Summary

The COVID-19 crisis will only make it more challenging for financial institutions to transition from LIBOR and meet the FCA's deadline of December 31, 2021. Banks are working to transition from LIBOR to RFRs, which are not genuine funding sources for banks. This presents a new risk as bank lenders will need to hedge out their RFR-to-genuine-borrowing-costs risks, leading to banks adding a spread that should be greater than necessary since the bank will need to pass on that risk through a higher spread

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[29] ARRC, "Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition" (6 Mar. 2020).

than it would otherwise have charged. Ultimately, borrowing from banks will become more expensive and there is potential for systemic risk being added to the market and to a bank's customers as a result of a mismatch between the interest rates a bank receives from its borrowers and pays to its funders in a time of financial crisis. It has been questioned whether now is the appropriate time to impose a nice-to-have, policy-driven change to lending markets, but the FCA has been firm in its deadline. Legislative solutions do not offer a complete "fix." A significant amount of work is still needed to address these risks and make it possible for firms to meet the deadline.

Recommended actions for banks' senior management aimed at reducing the risk of transitioning from LIBOR:

- Contribute to ensuring that the UK and US, as global financial hubs, play a leading role in urgently addressing the risks posed by the transition during this time of financial crisis.

- Support calls for the FCA to consider an extension to the deadline of December 31, 2021.

- Prioritize actions aimed at ensuring that the transition from LIBOR is effected in as seamless a way as possible. This could include amending legacy agreements based on LIBOR, building out technology-related enhancements and considering solutions such as the US Dollar ICE Bank Yield Index.

- Continue to work towards determining an appropriate bank risk spread on lending benchmarks.

VI. SENIOR MANAGEMENT AND CONFLICT ISSUES

RUSSELL SACKS, THOMAS DONEGAN AND SEAN KELLY

Proper information barriers and controls are always an important consideration for financial institutions. In times of crisis, the concerns associated with the misuse or perceived misuse of material nonpublic information, such as trading on that information, can easily become amplified. At such times, financial institutions should be hyper-vigilant with respect to information barrier and control policies, procedures, and safeguards. Given the current COVID-19 context, it is important for financial institutions to bear in mind these issues surrounding material nonpublic information and information barriers, as well as certain considerations with respect to how they may be affected by the pandemic.

Material Nonpublic Information and Information Barriers

Multiservice financial institutions establish information barriers to restrict the flow of material nonpublic information between private-side employees who regularly receive or develop that type of information, such as investment bankers and public-side employees who buy, sell or recommend the securities to which the information relates.

There is a distinction to be noted between public-side versus private-side business groups. Public-side groups do not have access to material nonpublic information on a routine basis, whereas private-side groups do and are assumed to have such access. Private-side groups include Investment Banking, Credit, Capital Markets, Syndicate and groups supporting and controlling these areas.

It is important to be aware of the historic importance of establishing information barriers and the various exemptions to the rules. Under the EU Market Abuse Regulation, an exemption from the civil prohibition on insider dealing is available where a legal person has “established, implemented and maintained adequate and effective” information barriers and has not influenced the natural person who made the deal in question on its behalf.[30] This is one of the “legitimate behavior” exemptions. In the US, the legislative history of the Insider Trading and Securities Fraud Enforcement Act reveals strong support for the idea that effective information barriers can provide a defense to alleged insider trading violations.

Information barrier policies and procedures initially adopted by firms generally focused primarily on the control of material nonpublic information obtained by investment bankers in connection with corporate transaction and advisory assignments. There are, however, other potential sources of material nonpublic information that require careful handling. For example, research departments’ knowledge of to-be-published research reports is considered to be material nonpublic information.

[30] Article 9(1), Regulation (EU) No 596/2014 of the European Parliament and of the Council of April 16, 2014 on market abuse.

In the UK, the FCA has emphasized that firms that have physical barriers between individuals or teams are able to "demonstrate more effective controls," and that where this is not possible, firms should consider taking extra steps to maintain their information barriers, including implementation of appropriate staff training and integration of the compliance function into front line operations. Use of the compliance function has also been highlighted as an effective way to manage wall-crossing; the FCA has observed that having a compliance team assess the necessity of wall-crossing, and who should wall-cross and when, makes for a consistent, centralized approach.

Financial institutions have flexibility to tailor information barriers, but the US Securities and Exchange Commission (SEC) and self-regulatory organizations (SROs) in the US, such as Financial Industry Regulatory Authority, Inc. (FINRA), have set certain minimum elements of an effective information barrier program, including:

- **Written Policies and Procedures**. Information barrier policies and procedures must be incorporated in a firm's procedure and policy manuals.

- **Wall-Crossing Procedures**. Firms must have "wall-crossing" procedures designed to facilitate situations that require an employee to cross an information barrier.

- **Restricted List and Watch List**. Firms should maintain and monitor restricted lists and watch lists, and, if necessary, restrict certain activities due to the possession of material nonpublic information.

- **Surveillance of Trading Activity**. Firms must take reasonable steps to investigate any possible misuse of material nonpublic information, including any transactions in restricted, or watch-list, securities.

- **Physical and Electronic Separation**. Information barriers must include arrangements for reasonable physical and electronic separation of public-side businesses (for example, sales and trading) from private-side businesses (for example, investment banking) that regularly receive confidential information.

- **Training and Education Programs**. Firms must establish and maintain reasonable training and education programs to ensure sufficient employee understanding of federal and state securities laws, SRO requirements, and the firm's policies and procedures to prevent the misuse of material nonpublic information.

- **Employee Attestation**. Firms must require each employee, at least once during the course of employment, to sign an attestation, to be maintained in the firm's files, of his or her knowledge of insider trading rules and regulations.

Material Nonpublic Information Considerations During a Crisis

Within financial institutions that possess material nonpublic information there will almost always be employees who have access to material nonpublic information from two or more private-side business lines. There will also be other "above-the-wall" employees who have private- and public-side responsibilities with access to material nonpublic

information. Many of these above-the-wall individuals hold senior executive or management roles at their respective firms.

Periods of crisis, including extreme market dislocation, high volatility or the potential for significant firm or customer losses can create increased pressures for persons in possession of material nonpublic information to use that information to protect their financial institution. Such use is often inadvertent and/or unintended. Further, times of crisis also result in senior management taking a more hands-on approach with respect to the day-to-day activities of their financial institutions. This can result in the inadvertent misuse of material nonpublic information with regard to these activities, or, given that decisions are reviewed in hindsight, the perception that material nonpublic information influenced decision-making processes.

Challenging circumstances, such as the current pandemic, often present novel and time-sensitive issues that require quick action and provide limited time to consider choice sets. Financial institutions should, however, consider that regulatory review of these decisions will always be evaluated after the fact with the benefit of hindsight. Because of this, financial institutions should be hyper-vigilant with respect to information barrier and control policies, procedures and safeguards during times of crisis.

Summary

Proper information barriers and controls are always an important consideration for financial institutions, and, in times of crisis, the concerns associated with the misuse or perceived misuse of material nonpublic information can easily become amplified. Periods of crisis can create increased pressures for persons in possession of material nonpublic information to use that information to protect their financial institution, which is often inadvertent and/or unintended. This can be driven as a result of senior management taking a more hands-on approach, or as a result of quick action and decision-making in response to novel and time-sensitive issues that can arise during times of crisis. Financial institutions should be hyper-vigilant with respect to information barrier and control policies, procedures and safeguards, given that regulatory review of any decisions will always be evaluated after the fact with the benefit of hindsight.

Recommendations for financial institution management with respect to information barriers during times of crisis:

- Be hyper-vigilant with respect to information barrier and control policies, procedures and safeguards.

- Firms should maintain physical barriers between individuals or teams, or, where that's not possible, take extra steps to maintain information barriers such as through additional training for staff or the integration of the compliance function into front line operations (*e.g.*, to help manage wall-crossing).

- Where required, adhere to the minimum standards set by the local regulator or law enforcement agency for an effective information barrier program.

VII. MANAGING FINANCIAL CRIME RISKS IN CHALLENGING CIRCUMSTANCES

PHILIP UROFSKY AND MATHEW ORR

Financial crime risks are ever-present, in any market and context, but they are often heightened during periods of disruption and economic uncertainty, as criminals seek to exploit new opportunities and perceived weaknesses in the system. As a result, while regulators and law enforcement agencies across the globe have shown a willingness to allow some flexibility in the way in which financial institutions address financial crime risks during the current COVID-19 crisis, they are clear that risks must be managed effectively and their legal and regulatory obligations met.

In the UK, on March 4 2020, HM Treasury, the Bank of England and the Financial Conduct Authority (FCA) issued a joint statement in which they said that they expected “all firms to have contingency plans in place to deal with major events” and that they expected them “to take all reasonable steps to meet their regulatory obligations.” Such a stance is in keeping with their drive to strengthen “operational resilience” within the financial services sector.

In the US, in a statement issued on April 3, 2020, the Financial Crime Enforcement Network (FinCEN) stated that it expected all financial institutions “to continue following a risk-based approach” and to “diligently adhere” to their obligations imposed under the Bank Secrecy Act. FinCEN noted that those obligations remain “crucial to protecting [US] national security by combating money laundering and related crimes, including terrorism and its financing.”

Most regulators and law enforcement agencies in other jurisdictions have adopted similar stances to those of the UK and US. As a result, financial institutions are currently considering two important issues. First, how they can continue to manage financial crime risks effectively when many of the tools they would normally use are not at their disposal, and, second, what regulators and law enforcement agencies will consider “reasonable” for them to do, or not do, in the current circumstances.

Of course, in practice, the answers to both of these questions will depend on a range of factors and will vary from case to case. However, in broad terms, regulators have taken the approach recommended by the Financial Action Task Force (FATF) in its statement issued on April 1, 2020, in which it encouraged governments “to work with financial institutions and other businesses to use the flexibility built into the FATF’s risk-based approach to address the challenges posed by COVID-19 while remaining alert to new and emerging illicit finance risks.”

Recent guidance issued by the FCA, in particular, provides some illustrative examples of the way in which regulators may react in response to the practical challenges some financial institutions are facing:

- In a statement issued on March 17, 2020, the FCA recognized that some firms may struggle to record trading calls as a result of employees working remotely. The FCA made it clear that it expected to be informed if this was the case and that firms should take steps to mitigate the risks, such as carrying out enhanced monitoring or retrospective reviews.

- In a further statement issued on May 6, 2020, the FCA provided other examples. Most notably, it stated that firms should not change or switch off transaction monitoring triggers and thresholds, or sanctions screening systems, for the sole purpose of reducing the number of alerts generated to address operational issues, but that some activities carried out following those alerts may need to be prioritized or delayed to meet operational challenges.

Regulators and financial intelligence units (FIUs) have also made it clear that firms should continue to meet their financial crime reporting obligations by continuing to file suspicious activity reports, suspicious transaction and order reports, and the like, while acknowledging that it may take them longer to do so than would otherwise be the case.

From these examples and similar guidance provided by other regulators and FIUs, it is clear that firms are expected to continue to monitor risks, collect data and secure relevant information insofar as is reasonably practicable. If they do not, it will be impossible for them to adopt a risk-based approach because they will not be aware of the threats posed to their businesses, those they do business with and the wider economy. However, there appears to be an acceptance that some institutions may face practical challenges (*e.g.*, a reduced workforce, staff working remotely, etc.) that may influence how risks are managed once they are identified. In those circumstances, firms should continue to adopt a risk-based approach to prioritize the management of the most serious and pressing risks. Having collected data and secured relevant information at the appropriate time, firms will be able to address less serious and pressing risks as and when circumstances allow.

It is also clear FIUs expect information to continue to flow from financial institutions. First, they expect to be made aware of any significant challenges that firms are facing in managing financial crime risks and in meeting their legal and regulatory obligations, as well as the steps being taken by firms to address those challenges. Second, they expect to be made aware, through existing channels, of identified risks to allow them to continue to take appropriate action on a case-by-case base, as well as addressing wider risks (*e.g.*, through the sharing of information with third parties, developing disruption techniques, highlighting risks to other financial institutions or the public at large, etc.).

Regulators, law enforcement agencies and FIUs are particularly keen to learn of wrongdoing directly related to COVID-19. FIUs in the UK, the US and elsewhere have asked those filing suspicious activity reports to highlight COVID-19-related crime, and dedicated task forces have been created to investigate and prosecute such criminality. Financial institutions have been encouraged to play their part by detecting and preventing such behavior, and by publicizing new and emerging risks, such as the vast array of scams that have been developed to take advantage of the current situation,

often targeting individuals and businesses that are exposed and vulnerable. Financial institutions should also be alive to the fact that many of the financial stimulus measures that have been designed and implemented at speed are ripe for abuse. Those processing loans and other measures will need to be especially vigilant and to manage the risks associated with them appropriately.

While the scale of the current crisis is unprecedented, many of the risks that financial institutions are currently facing will not be new, but they may be more prevalent or present themselves in different ways. In recent years, we have seen borders closed, travel restrictions imposed, workforces displaced and IT systems compromised due to a broad range of events, including natural disasters, regional conflicts, political coups, terrorist incidents and cyber-attacks. An example of what firms are seeing at present is that an increased risk of bribery and corruption is likely to emerge as they seek out new supply chains, look to establish new trading relationships, or come under pressure to meet sales targets.

Similarly, instances of fraud (over and above those directly related to the current pandemic) are likely to increase due to the economic climate. Some frauds will be perpetrated against customers of financial institutions by third parties, while others will be perpetrated by customers and third parties against financial institutions. Financial realities may also lead businesses, including financial institutions and those employed by them, to engage in wrongdoing to mask financial ill-health or to make gains for themselves. Experience also shows that the "receding tide" of a crisis often leads to the uncovering of pre-existing frauds and other criminality. As Warren Buffett noted, "only when the tide goes out do you discover who's been swimming naked."

The very real challenge for financial institutions is meeting all of these increased risks at a time when they are unlikely to have all of the usual tools at their disposal to do so, particularly as many of the most effective methods often involve face-to-face contact. Again, examining recent guidance can provide firms with an insight into what regulators and law enforcement agencies may expect them to do when in-person checks are not possible.

Due diligence on both individual and corporate clients and counterparties remains one of the most effective tools in managing financial crime risks in all their forms. While it is possible to carry out some checks remotely, the process normally involves carrying out in-person checks for anything other than straightforward, low-risk relationships and transactions. With face-to-face meetings simply not possible in large parts of the world at the present time, regulators have told firms that they should not be afraid to be innovative and flexible to meet their obligations under existing legislative and regulatory frameworks.

With respect to individuals, in many jurisdictions, including the UK and the US, financial institutions are already permitted to verify a customer's identity using digital means if considered appropriate. FATF has also encouraged "the use of technology, including Fintech, Regtech and Suptech to the fullest extent possible" in line with FATF standards. In a "Dear CEO" letter published on March 31, 2020, the FCA put forward a number of practical ways in which firms could meet their obligations in the current circumstances:

- accepting scanned documentation sent by e-mail, preferably as a PDF;
- seeking third-party verification of identity to corroborate that provided by the client, such as from its lawyer or accountant;
- asking clients to submit “selfies” or videos;
- placing reliance on due diligence carried out by others, such as the client’s primary bank account provider, where appropriate agreements are in place to provide access to data;
- using commercial providers who triangulate data sources to verify documentation provided;
- gathering and analyzing additional data to triangulate the evidence provided by the client, such as geolocation, IP addresses, verifiable phone numbers;
- verifying phone numbers, e-mails and physical addresses by sending codes to the client’s address to validate access to accounts; and
- seeking additional verification once restrictions on movement are lifted for the relevant client group.

Finally, it is important to note that financial institutions may be asked to account for their deviations from those policies and procedures that are normally applied, and to justify any decisions made. As a result, firms would be wise to ensure that such decisions are well documented as it may be months or potentially years before current events are fully explored.

Financial institutions may play many roles with respect to financial crime risk—they may be victims, perpetrators, or willing or unwitting facilitators. From the perspective of governments, regulators and law enforcement agencies, they play a vitally important role as gatekeepers. Maintaining, updating and investing in compliance controls will help keep an institution on the right side of the line and avoid the costly and significant consequences of straying over it.

Summary

Financial crime risks are ever-present and are often heightened during periods of disruption and economic uncertainty. The COVID-19 pandemic is no exception, and while many of the risks that financial institutions are currently facing will not be new, the way in which they present themselves and the tools available to deal with them may well be different, particularly as many of the most effective methods often involve face-to-face contact. While regulators and law enforcement agencies around the world have allowed some flexibility in the way in which financial institutions manage financial crime risks, they are clear that risks must be managed effectively and that firms must meet their legal and regulatory obligations.

Recommended actions for financial institutions to manage financial crime risks effectively and to be prepared for future periods of disruption including the following:

- **Maintaining core compliance functions during periods of disruption**. Doing so must be at the heart of any business continuity or contingency plan. Such plans must be meticulously prepared and stress-tested for a range of scenarios, including prolonged disruption over many months. Too often, plans are designed to cater to short-term interruption, allowing financial institutions to defer many issues to another day.

- **Continuing to invest in robust and secure IT infrastructure and systems**. Such investment is essential to allow financial crime risks to be managed remotely. Even in "normal" circumstances, many risks are detected and monitored at a distance with staff responding to automatically generated red flags. The current pandemic is likely to lead to the acceleration of the development and implementation of a range of technological solutions that will be used to manage financial crime risks, such as automated reporting, cognitive computing, machine learning, robotic processing and data analytics. Of course, as technology plays an ever-increasing role in everyday life, and in the management of financial crime risks in particular, financial institutions must ensure that adequate mechanisms are in place to protect themselves, their customers and those they do business with from IT outages and cyber-related crime.

- **Investing in people, even while managing costs and resources in a time of economic stress**. While technology has an important role to play, people are always going to play a key role at the heart of an effective compliance program. This is because many of the decisions that must be made involve the exercise of judgement and cannot be automated or replicated by technology. Financial institutions will therefore be wise to continue to employ and retain those with the correct skillsets to meet the demands of their business. Current events have also highlighted the benefits of employing a well-trained and agile workforce that can be deployed in a range of situations.

- **Building strategic relationships with external partners**, such as lawyers, accountants and forensic technology companies, to whom you can turn at short notice when challenging circumstances arise. Such people should have the knowledge and experience to complement an institution's in-house talent and, wherever possible, should be familiar with the processes and procedures adopted by the financial institution to allow them to "hit the ground running."

- **Reviewing and updating financial crime policies and controls to address new and emerging risks**. These policies and controls should be well thought through and clearly articulated so that employees and those that do business on behalf of, or with, a financial institution know what is expected of them. This is particularly important as financial institutions explore whether certain financial crime functions can be outsourced to third parties. Effective policies also set the tone from the top and establish the importance of compliance to an institution.

When faced with challenging circumstances, they provide a clear focus for those managing financial crime risks and the business as a whole.

- **Having in place effective procedures to meet legal and regulatory obligations, as well as wider policy objectives**. Such procedures must be capable of being revised and adapted to cater to a broad range of challenging circumstances. As the current crisis has shown, provided legal and regulatory requirements are met, financial institutions are likely to be afforded a certain degree of flexibility in the procedures they adopt during periods of disruption. The key issue for regulators and law enforcement agencies is whether they are effective in managing the risks posed to a firm.

- **Providing topical, accessible and relevant training in the policies and procedures adopted**. This is one of the key measures used by regulators to assess a financial institution's effectiveness in managing financial crime risks. During periods of disruption, firms should be ready to rollout training programs at speed as circumstances change and risks develop. If new procedures are adopted, employees should be informed and trained appropriately. As current events have demonstrated, there are a number of ways in which such training can be delivered quickly and remotely (*e.g.*, through pre-recorded presentations, interactive sessions by video or telephone, online courses and assessments, etc.).

- **Maintaining effective lines of communication with regulators and other relevant internal and external stakeholders**. During periods of disruption, financial institutions must be ready to provide regular updates to customers and those they do business with, as well as regulators and other interested third parties. It is also vital that those within a financial institution are made aware of significant developments and what is expected of them in the circumstances. The current crisis has also demonstrated the importance of effective communication within and between teams, particularly when they are working remotely or at different locations.

- **Ensuring that delegations of authority are clearly articulated and updated to reflect organizational changes**. When operating in challenging circumstances, decision-making often happens at speed. It is vitally important that all concerned are aware of who will be making decisions and how they will be made. Once made, all significant decisions should also be well documented, as individuals and financial institutions may be asked to account for their actions at a future date.

- **Being cautious in applying across-the-board cost-cutting to compliance functions**. In the coming months and years, some financial institutions may be looking to cut costs to improve their financial health and some may be tempted to scale back compliance and investigation functions. Experience suggests that any financial institution should think very carefully before doing so, especially if it engages in business activities or operates in locations with increased financial crime risks. Short term gain may well lead to long term pain.

VIII. FORECLOSING ON INDIVIDUAL AND FUND CLIENTS

RUSSELL SACKS, JENNIFER MORTON AND THOMAS DONEGAN

Periods of extreme economic distress and disruption, such as the current COVID-19 crisis, increase the possibility of customers of financial institutions experiencing compound losses in their margin accounts. Such losses may bring these accounts below the minimum maintenance margin or house margin requirements. In these circumstances, broker-dealers have the right to issue a margin call, requiring the customer to deposit additional cash or securities in the account to satisfy applicable margin requirements. To the extent the customer fails to satisfy the margin call, the broker-dealer has certain contractual rights that include liquidating the assets in customer margin accounts in a manner consistent with the applicable laws and regulations, and the terms of the customer account agreement, to prevent additional losses and subsequently terminating the contract with the customer.

The sections below describe the margin rules and regulations in the EU and US; certain contractual rights that a broker-dealer can exercise if the value of a customer's margin account goes below certain thresholds; and some scenarios that retail broker-dealers may face when confronted with customers who have experienced significant losses in their margin accounts as a result of market volatility.

Margin Requirements in the UK/EU and US

In general, there are two types of required margin: initial margin and maintenance margin. Initial margin refers to the minimum amount of equity required for an investor to begin trading on margin, with new securities transactions and commitments generally having an initial margin requirement of 50% of the current market value of the security. Maintenance margin refers to the percentage of equity that an investor must maintain in their account.[31]

Financial institutions also maintain internal policies and procedures that set additional, and often more stringent, margin requirements than those issued by authorities and regulators. Such requirements are commonly referred to as "house" maintenance margin requirements.

The EU Capital Requirements Regulation implements the Basel Committee credit risk framework that requires banks and large investment firms to hold capital (own funds) to reflect the risk of their activities, including margin lending activities. Where the collateral is not cash or government bonds, higher haircuts (reductions applied to the value of an asset) are applied, so a greater nominal amount of assets must be provided. The margin required for a customer's margin account is determined on a daily basis, based on the overall exposure and credit risk profile of the counterparty.

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[31] FINRA Rule 4210(c)

Margin lending transactions are also in-scope of the Securities Financing Transactions Regulation (SFTR). Counterparties to margin lending (a type of SFT for the purpose of the SFTR) are required, subject to certain exceptions (including for certain types of retail transactions), to report their SFTs to a registered trade repository. This obligation was due to come into effect on April 13, 2020, but in light of the COVID-19 pandemic, the European Securities and Markets Authority has granted regulatory forbearance until July 13, 2020, including for SFTs subject to the backloading requirement.

In the US, regulators have adopted a particularly conservative approach to the application of margin regulations during periods of market volatility in order to prevent the buildup of excess leverage in the market, to preserve the stability of the financial system, and to protect customers from suffering compounded losses in margin accounts. The terms under which US financial institutions, such as broker-dealers and banks, can extend credit for securities transactions are regulated by Federal Regulations, the rules of the Financial Institutions Regulatory Authority, Inc. (FINRA), and the securities exchanges.

Common Margin Account Agreement Provisions

The limitations mandated by applicable laws and regulations and house margin rules are captured in the account agreement entered into by customers prior to the opening of a margin account. The following describes contractual rights that broker-dealers have in margin account agreements:

- **Margin limits**. These limits give the broker-dealer discretion to change or decrease the parameters of allowable margin or margin call time-periods in the customer account.

- **Margin calls**. These provisions, sometimes referred to as "nervousness clauses," permit the broker-dealer to make margin calls at any time to satisfy either maintenance margin required by regulation or house maintenance margin requirements. The broker-dealer may issue a margin call without prior notice to a customer and, in its sole discretion, may demand that the call be satisfied immediately or within a specified period of time.

- **Lien on customer assets**. Lien or pledge of all customer assets in margin accounts in favor of the broker-dealer. In the case of cross-default, the lien may apply to assets the customer has in other accounts with the broker or in accounts with an affiliated institution. Broker-dealers may also enter into title transfer collateral arrangements with clients. This is subject to applicable regulatory rules. In the EU, for example, Markets in Financial Instruments Directive II (MiFID II) provides that investment firms may not enter into title transfer collateral arrangements with retail clients for the purposes of securing obligations.[32]

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[32] Article 16(10), Directive 2014/65/EU of the European Parliament and of the Council of May 15, 2014, on markets in financial instruments (*see* CASS 7.11.1 R of the UK's Financial Conduct Authority Handbook for an example of implementation of this provision). For non-retail clients, MiFID II requires investment firms to consider and document the appropriateness of the use of any title transfer collateral arrangements in the context of the relationship between the client's obligations to the

- **Liquidation of customer assets**. The broker-dealer may liquidate securities without prior notice to the client and, because the securities in a margin account serve as collateral for the margin loan, the broker-dealer has the discretion to decide which securities may be sold in order to meet a margin call. Rights of reuse (broadly, rights for the broker-dealer to use assets received under the collateral arrangements for its own purposes other than liquidation in the event of a default) may also be provided for, subject to the applicable regulatory framework. For example, the EU's SFTR makes rights of reuse subject to certain conditions, including that the counterparty providing the instruments is informed in writing of the associated risks and consequences or gives prior express consent.[33]

- **Margin Disclosure Statement**. In the US, pursuant to FINRA Rule 2264, no broker-dealer may open a margin account on behalf of a retail customer unless, prior to or at the time of account opening, the broker-dealer gives the customer the disclosure set out in the rule. The disclosure statement sets out the risks of margin accounts, including the possibility of liquidation of assets to satisfy a margin call.

- **Termination Clause**. The broker-dealer or the customer may terminate any customer accounts, including any margin account, held by the broker-dealer at any time upon prior notice to the other party.

These underlying contractual rights, and in particular the disclosure requirements, serve as compelling defenses for financial institutions in situations where customers who have experienced losses in their margin accounts bring, or contemplate bringing, arbitration or litigation claims against their brokerage firms.

Implications of Margin Rules in Periods of Market Volatility

In periods of market volatility or economic distress, such as that being experienced during the current COVID-19 pandemic, customers may experience losses in margin accounts that are compounded by leverage in those accounts. In addition, individuals who have incurred losses may wish to recoup those losses through taking on increased leverage or through placing speculative trades, but may be prevented from doing so by their brokerage firms due to house margin requirements or the regulatory margin requirements. Accordingly, financial institutions should expect that periods of market volatility may lead to an increase in customer complaints and/or difficult customer interactions.

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firm and the client assets that would be subjected to the arrangements (Article 6, Commission Delegated Directive (EU) 2017/593 of April 7, 2016, supplementing Directive 2014/65/EU of the European Parliament and of the Council).

[33] Article 15, Regulation (EU) 2015/2365 of the European Parliament and of the Council of November 25, 2015 on transparency of securities financing transactions. *See also* the conditions attached to the right of reuse by the Financial Collateral Directive (Directive 2002/47/EC of the European Parliament and of the Council of June 6, 2002, on financial collateral arrangements).

In this regard, customers who have experienced significant losses may seek to make claims on the grounds of a failure to apply suitability requirements, disclosure failures, issues relating to the fair treatment of customers, negligence or mis-selling. With respect to suitability, customers may allege that either they were not suitable for the opening of a margin account, or that the allocation or concentration of securities in their account was unsuitable to their particular investment profile. In addition, as increasing market volatility results in margin calls and the liquidation of securities in margin accounts in order to meet margin calls, customers may bring complaints alleging negligence or even bad faith on the part of the firm in the execution of the margin call. As discussed previously, regulators have generally found that disclosures in customer account agreements, which allow firms latitude to liquidate the securities of their choosing in the manner of their choosing, are protective of broker-dealers. Note, however, that the specific fact pattern underlying any particular complaint or allegation remains critical to the final resolution of that complaint or allegation. In the retail context, broker-dealers should also carefully consider the applicability of any relevant consumer protection laws.

Accordingly, while it may be unlikely for an action brought by a customer in the handling of a margin call to succeed, firms should nevertheless expect and prepare for an increase in difficult customer interactions, and should continue to maintain open lines of communication with customers who have experienced losses in their margin accounts in order to maintain a positive customer experience and mitigate against any potential claims.

Summary

In periods of market volatility or economic distress, such as the COVID-19 pandemic, customers of financial institutions may experience compound losses in their margin accounts. There is a process for broker-dealers to follow when individual and fund clients default, and they must respond in a way that is consistent with the margin rules and regulations of their jurisdiction and with the customer account agreement. There are risks to financial institutions associated with this process, and they should expect an increase in customer complaints and/or difficult customer interactions during periods of market volatility, which can lead to customers who have experienced significant losses seeking to make claims against them. While it is unlikely that an action brought by a customer in such an instance will succeed, the underlying details and fact pattern of the particular complaint or allegation will be critical to the final resolution.

Recommended actions for financial institutions when customers experience compound losses in their margin accounts:

- Be clear on the margin rules and regulations in your jurisdiction, as well as the contractual rights and disclosure requirements you have in margin account agreements.
- Have a well-defined process in place with good documentation in order to manage defaults smoothly and avoid future issues.

- Be prepared for an increase in customer complaints and/or difficult customer interactions during periods of market volatility.

- Maintain open lines of communication with customers in order to maintain a positive customer experience and mitigate against any potential claims.

IX. ISSUES ARISING FROM 'COVENANT LITE'

ALAN ROCKWELL, MICHAEL CHERNICK AND PETER HAYES

The ongoing COVID-19 crisis continues adversely to affect the global economy—and the operations and financial condition of businesses across almost every industry and sector. This paper outlines the issues arising from the "covenant lite" lending environment of recent years and discusses concerns and issues for lenders and borrowers that are arising as a result of the COVID-19 crisis. Both lenders and borrowers will need to consider multiple issues that may affect them under their loan documents. In doing so, there are certain key provisions of English law and New York law loan agreements which need to be evaluated in order to determine how the crisis will affect a borrower's ability to meet its ongoing obligations.

Drawing Requests—Bringing Down Representations and Warranties

Since the beginning of the crisis, many borrowers have accessed their revolving facilities and other committed undrawn facilities, to maximize their liquidity position. The two key conditions that a borrower must meet in order to borrow under these types of facilities are:

- that there is no default; and
- that the representations and warranties are true and correct on the date of, and after giving effect to, such borrowing. The analysis varies according to whether English or New York law has been used.

English law

In English law, for a rollover of an existing working capital loan, it is customary for the borrower to be free to do this absent acceleration by the lenders; some agreements may require that there is no event of default. For new money drawings, in addition to there being no default, only the so-called repeating representations need to be accurate. These are a small subset of the representations. The absence of a material adverse change to the financial condition of the borrower and the continued solvency of the business are covered through the "no default" condition by reference to the no material adverse change and insolvency events of default, although there are now loan agreements that do not contain a "material adverse change" event of default.

New York law

The specific language for representations and warranties varies widely, but it is highly likely that each New York law loan agreement will contain:

- some form of "material adverse effect" representation, which usually measures, among other things, any change in a borrower's financial condition since the original date of the loan (or the date of the latest audited financial statements delivered prior to the original date of the loan); and

- some form of customary solvency representation.

Material Adverse Effect Clauses

There have been numerous questions raised about whether the current COVID-19 lockdown restrictions that have been widely imposed throughout the US, UK and beyond, and the resulting impact (in terms of closures and suspensions of many businesses and related drops in revenue), have caused a "material adverse effect" to occur. There are various points to note:

- The "material adverse effect" concept is not specifically defined in any legislation and there is very limited judicial guidance available under either English law or New York law on interpreting the meaning of such term but it is generally understood that lenders seeking to rely on this as a "drawstop" will have to meet a high burden of proof in evidencing that there has been a "material adverse effect".

- The exact definition of what constitutes a "material adverse effect" will vary widely across different loan agreements. Issues to consider in New York law agreements include:

  - does the definition include a reference to "prospects?" This would include a forward-looking element to the determination, which is especially relevant in light of the ongoing uncertainty around how long lockdown restrictions may remain in place;

  - does the definition apply an objective standard ("…has caused") or a more subjective forward-looking standard ("…could reasonably be expected to…");

  - typically, material adverse effect references three customary impacts: impact on the borrower's business or financial condition; impact on the borrower's payment obligations; and impact on the agent's rights and remedies—check if one or more of these impacts does not apply; and

  - check if loan agreements include carve-outs for any previous public disclosures, in particular if these are drafted broadly enough to cover broadly drafted risk factors included in securities offering documents or information included in periodic public reporting.

- In addition to the above, and again for NY law agreements, based on judicial guidance of similar provisions in acquisition agreements, it is generally considered that for a "material adverse effect" to occur in relation to a borrower's business or financial condition:

  - the adverse impact must be sufficiently material—*e.g.*, a large reduction in revenue or EBITDA or assets (not substantially covered by insurance or available relief programs); and

    - the adverse impact must be expected to last for a significant period of time.

- For English law agreements, the analysis is similar. Any change cannot be temporary and the impact must significantly affect the borrower's ability to perform its obligations and its ability to repay the loan. A claim based on a material adverse change in financial condition should start with an analysis of the borrower's financial information at the relevant times; *i.e.*, a comparison of historical data against current data.

In general, a lender that seeks to assert that a "material adverse effect" has occurred should be cautious as to whether a short-term economic downturn constitutes a "material adverse effect." Such determination must be made on a fact-specific basis, based on the wording in the loan agreement and the facts surrounding the impact of the COVID-19 crisis and other specific factors affecting the borrower and this analysis will be specific to each different borrower. This is a difficult determination in light of the current uncertainty over how long lockdown restrictions may remain in place (and, once lifted, the risk of them being reimposed), and how quickly business operations will be able to resume, and under what conditions, once they are lifted. If a lender makes such a determination incorrectly, this could result in a risk of lender liability.

Solvency

Under New York law loan agreements, borrowers may also need to bring down their solvency representation in connection with a new borrowing. Lenders will need to check the loan agreement to confirm whether such representation needs to be brought down to each borrowing date or if it is limited to just the closing date. Solvency representations may vary among loan agreements, but in general they require borrowers to certify that:

- the fair value of their assets exceed the total amount of their debt and other liabilities;

- the present fair saleable value of their property is greater than the amount that will be required to pay the probable liabilities of their debt and other liabilities;

- they are not engaged in business for which they have unreasonably small capital; and

- they will be able to pay their debts and liabilities as they become due.

Reporting Obligations

Reporting and notification obligations to lenders vary between loan agreements, but English law and New York law loan agreements typically include, among other things:

- periodic financial statements and related financial information, and where applicable, accompanying auditors reports and related compliance certificates;

- budgets;
- notices of defaults and events of default;
- matters relating to litigation and material contracts and/or developments expected to have a material adverse effect; and
- other information requested by lenders.

Borrowers will need to review their obligations to provide notices under their debt documents and any deadlines by which they are required to deliver any required information and notices. Even where a grace period applies, a notice may still be required. Lenders will need to monitor compliance with these ongoing obligations, and it is anticipated that lenders will receive many requests for extensions of deadlines (or temporary waivers for missed deadlines) due to the impact on operations caused by ongoing lockdown restrictions in many locations.

Many borrowers who have upcoming delivery obligations for annual audited financial statements and accompanying auditor reports may be unable to meet the deadline for delivery because their auditors have been unable to complete audit procedures (in particular, those that require site visits) on their clients' financial statements on a timely basis. Lenders will likely be asked by many borrowers for an extension or temporary waiver, and will need to consider how long an extension to grant, and how to address any knock-on impact on financial covenants and negative covenants in loan agreements that may occur as a result of any delay in delivery.

Financial Maintenance Covenants

Under both English law and New York law loan agreements, lenders and borrowers will need to assess the impact of the COVID-19 pandemic on borrowers' ability to comply with their financial covenants, which usually are either a leverage ratio test or an interest or fixed-charge coverage test, measured at the end of each fiscal quarter. Each of these tests typically measure EBITDA over a last four fiscal quarter period, so as a result, the negative impact of the COVID-19 outbreak could continue well into 2021 for businesses. In covenant-lite deals, many borrowers may need to test "springing" financial covenants for March 31, 2020, and for future fiscal quarters (in the event that the springing trigger was in effect on such dates due to revolver drawings made prior to quarter end).

To the extent that a borrower engages in discussions with its lenders for covenant relief (which can take several different forms including a covenant suspension for a period of time or re-setting the covenant to provide additional cushion), lenders will need to consider what credit enhancements they should seek in return as a condition. Such enhancements could include the provision of additional guarantees and collateral and/or tightening of certain of baskets in negative covenants to limit value leakage on a temporary or permanent basis. They may also involve adding a new minimum liquidity based covenant and reporting for the duration of any covenant suspension.

In addition to possible waivers or amendments to financial covenants that are at risk of being tripped, borrowers and their owners may consider pre-emptive injections of equity to ensure covenant compliance and designate the same proceeds as cure amounts to equity cure a covenant breach.

EBITDA and Consolidated Net Income Add-Backs and Exceptions

Under both English law and New York law loan agreements, lenders and borrowers will need to scrutinize certain financial definitions (such as "consolidated net income" and "consolidated EBITDA" and similar terms) in loan documents. This will enable them to determine if add-backs (such as for extraordinary, unusual and non-recurring expenses and for cost savings) could be utilized to limit the amount of the impact on financial covenant compliance resulting from decreased net income or EBITDA as a result of the COVID-19 pandemic.

Such definitions are highly negotiated and will vary widely between different loan agreements.

Lenders should be aware that adjustments to financial definitions will likely have implications beyond financial covenant compliance. Implications may include step-downs for asset sale and excess cash flow mandatory prepayment provisions and certain covenant baskets (such as additional debt and lien incurrences, investments, restricted payments and restricted debt payments) which may grow as EBITDA increases or include certain baskets for debt incurrence, liens, investments, restricted payments or restricted debt payments based on meeting a ratio condition that may be met if certain add-backs are included.

Alternative Sources of Financing and Cash Preservation

In addition to drawing funds under its revolving facility, a borrower may want to seek alternative sources of funding to enhance its liquidity position. English law and New York law loan agreements of non-investment-grade borrowers will generally have restrictive covenants that will, among other things, limit a borrower's and certain of its subsidiaries' ability to incur debt and liens, make investments and transfer or otherwise dispose of assets. These covenant packages can vary widely and are highly negotiated, however, over the past few years the baskets negotiated in a substantial number of transactions have loosened significantly.

Even with a material degradation of a borrower's business, using availability under some common baskets, a borrower and its subsidiaries (including subsidiaries that are not guarantors) may be able to incur indebtedness, grant liens on their assets (which may include assets that are not required to be part of the existing lenders' collateral package), make investments in, and transfer assets to, non-guarantor subsidiaries and prepay certain types of junior debt.

Many companies may seek to utilize debt basket capacity for receivables financing and securitization financing and/or seek to utilize supply chain financing as ways of

providing additional liquidity to shore up any temporary shortfalls in revenue caused by the COVID-19 crisis that cannot be covered by other permitted debt or equity financing.

In addition, many loan agreements permit borrowers to create unrestricted subsidiaries that will not be subject to any of the restrictive covenants in the loan documents and may be able to transfer assets to such unrestricted subsidiaries using available capacity under applicable investment and restricted payments baskets, resulting in value leakage to the lenders' credit support.

Lenders should anticipate borrower requests for payment holidays, deferral of amortization payments or mandatory prepayment of excess cash flow or asset sale proceeds, and/or requests for conversion of cash interest payments into capitalized payment-in-kind payments, as additional ways of preserving or creating liquidity.

Lenders under Asset-Based Lending (ABL) facilities (which are more common under New York law) should consider the impact on borrowing base eligible collateral caused by payment defaults by customers (resulting in ineligibility of receivables), and impacts on suppliers, carriers and inventory (or borrower inability to pay suppliers), reducing available collateral for inclusion in borrowing bases.

Events of Default

A breach of any covenant (after the expiry of any applicable grace periods), including financial and notification covenants, or the failure of any representation to be correct in all material respects when made, could trigger an event of default under the relevant loan documents. In addition to such breaches, the following customary events of default may be relevant in the context of the COVID-19 crisis:

- **Payment Defaults**. A borrower's failure to pay principal, interest and fees when due will generally trigger an immediate event of default (with respect to failures to pay principal) or have very short cure periods.

- **Cross-Defaults**. Loan documents typically contain a cross-default in respect of events of default and/or failures to make payments under other indebtedness above a certain threshold. Borrowers and their lenders, therefore, should be aware of the relevant terms and thresholds across their loan documents and such borrowers' other debt instruments. Additionally, some loan documentation may contain business-specific cross-defaults relating to defaults or suspension in respect of performance under material third-party contracts.

- **Insolvency**. Borrowers and lenders should carefully review the applicable provisions for the "bankruptcy event of default," as there may be circumstances other than an actual bankruptcy proceeding that could cause there to be an event of default. For instance, certain credit facilities provide that if the borrower admits in writing its inability to pay its debts, such event would constitute an event of default. Another example is that in certain credit facilities "insolvency proceedings" may include negotiations with creditors. Companies with non-US

subsidiaries should be especially vigilant about the risk that local subsidiary bankruptcies would be triggered by balance sheet insolvencies.

- **Cessation of business**. English law loan agreements contain “cessation of business” events of default that should be carefully reviewed. These will cover suspension of business and threats to suspend or cease business and may be implicated by the measures that companies have to comply with due to the COVID-19 lockdown.

Applicable grace periods would need to be considered for all events of default. In some cases, the event of default may have no grace period. Lenders and borrowers should also be aware that the notification requirements may be triggered when the grace period commences rather than at its expiry.

Loan Buybacks

The sharp decline in the market prices of loans in the secondary markets are causing companies and their affiliates to consider debt repurchases. Prior to the 2007–08 financial crisis, most loan agreements did not contemplate or permit the borrower and its affiliates to purchase the borrower’s loans.

However, it is now common to allow purchases of loans (usually limited to term loans). Although the terms of a particular loan agreement may vary, in general, a borrower (or one of its subsidiaries) will be permitted to purchase its own loans (which loans then need to be cancelled), either through open market purchases or through voluntary discounted prepayments through Dutch Auction procedures, so long as no event of default then exists and no proceeds from the borrower’s revolving credit facility are used to make such purchases.

Affiliates of the borrower are also generally permitted to purchase the borrower’s loans subject to a cap (generally 25–30% of the loans). In these circumstances, such affiliates will have limitations on their access to information and “lender only” meetings and their voting rights and will waive certain rights in bankruptcy proceedings. These limitations usually do not apply to “debt fund affiliates,” but loan agreements will often limit the aggregate voting rights of such debt fund affiliates.

Banks that want to assist their clients in facilitating loan buybacks will need to consider certain issues in how they execute such trades on behalf of such clients. The fact that the borrower and/or one of its affiliates is in the market looking to purchase a portion of the outstanding loans (depending on the size of such purchase) may be deemed material non-public information with respect to such borrower and its securities. Although bank loans are not considered to be securities, banks will need to consider whether they should execute these trades in a manner that is similar to how they execute stock buybacks for their clients. Accordingly, banks will need to decide whether they will require that information relating to any such trades should be limited to its private-side restricted trading desks or if it can be shared with its public non-restricted desks. Similarly, banks will need to consider which of its trading desks (public vs. restricted) should be involved in executing such purchase and sale transactions.

Debt buybacks do raise a number of further issues; see *S&S Perspectives: Debt Buyback and Liability Management Considerations*.

Summary

Recommendations for lenders with regards to the impact of the COVID-19 pandemic on the “covenant lite” lending environment:

- Lenders must consider the issues that may affect them under their loan documents and evaluate the provisions of English law and New York law loan agreements.
- A lender that wants to assert that a “material adverse effect” has occurred should be cautious as to whether a short-term economic downturn constitutes this, which must be made on a fact-specific basis. This could result in a risk of lender liability if such a determination is made incorrectly.
- Lenders will need to monitor borrowers’ compliance with their ongoing obligations, such as providing notices under their debt documents and adhering to associated deadlines. Lenders should expect to receive many requests for extensions of deadlines due to the impact that lockdown restrictions have and are having on operations.
- Lenders and borrowers will need to assess the impact of the COVID-19 pandemic on borrowers’ ability to comply with their financial covenants. Where covenant relief is requested, lenders must consider what credit enhancements they should seek in return as a condition.
- Lenders must scrutinize financial definitions such as “consolidated net income” in loan documents to determine if add-backs could be utilized to limit the impact on financial covenant compliance resulting from decreased net income or EBITDA.
- Lenders should anticipate borrower requests that will help preserve or create liquidity, such as payment holidays, deferral of amortization payments or mandatory prepayment of excess cash flow or asset sale proceeds.
- Banks that want to assist their clients in facilitating loan buybacks will need to consider certain issues in how they execute such trades. For example, the fact that the borrower is looking to purchase a portion of the outstanding loans may be deemed material non-public information.

X. WHAT TO DO WHEN CORPORATE LOANS GO WRONG

FRED SOSNICK

The initial phases of the COVID-19 crisis have led to a dramatic increase in corporate restructurings. In addition to financial covenant issues and near-term maturities that led to significant numbers of restructurings and bankruptcies in previous economic downturns, the new world of COVID-19 has resulted in an unprecedented number of companies experiencing nearly overnight liquidity concerns.

Although the causes of liquidity concerns for businesses—particularly among companies that are dependent upon direct interactions with consumers—resulting from the COVID-19 pandemic may be new, the tools to address those issues are similar to those that were utilized in pre-COVID restructurings.

It often is difficult to accomplish a comprehensive balance sheet restructuring without binding dissenting holders to the restructuring. For example, it would be unpalatable to most lenders/bondholders to have their debt converted to equity if they knew that similarly situated creditors were still entitled to receive payment in full under an existing debt instrument. Binding dissenting creditors to a restructuring typically involves an in-court process.

The two most common in-court regimes are a scheme of arrangement under English law and a chapter 11 case under US law. The UK has also introduced three major reforms of its insolvency and restructuring laws (in the Corporate Insolvency and Governance Act 2020 (CIGA), effective June 26, 2020) that will be of significant help to companies that need to restructure and fall within the UK restructuring jurisdiction. These reforms are a new form of restructuring scheme (a restructuring Plan), a new standalone moratorium and a new bar on the triggering of automatic (or *ipso facto*) termination clauses in goods or services supply contracts.

The new UK restructuring Plan—only available to companies with financial difficulties—will offer some key advantages over a scheme. These include the ability for “cross-class cram down” of creditors (or stockholders) and the application of the new bar on automatic termination clauses. Neither of these will available for a scheme.

Each approach—a UK scheme or UK restructuring Plan or a US chapter 11 case—has its own advantages. One of the biggest advantages of a UK scheme is that it is not an insolvency proceeding for the purposes of the EU Insolvency Regulation, since it is accomplished under the UK Companies Act. This means it is generally not considered an insolvency proceeding for purposes of cross-defaults. This is also expected to be the case with a UK restructuring Plan, although that will depend on the relevant drafting.

Until CIGA came into force, a major drawback of a UK scheme has been the lack of any moratorium to protect the company while it is formulating its restructuring proposals. This has now changed with the introduction of the new standalone moratorium.

Companies that are eligible for the moratorium—certain companies are not, including financial services and related companies—will be able to file papers with the court and appoint a "monitor" to oversee the directors' continuing management of the company during the moratorium. Creditor action against the company will be largely stayed while the moratorium continues. The moratorium does not have to have any particular outcome in mind and the company may make an application to the court to extend the moratorium if it starts the court process for a UK scheme or a UK restructuring Plan.

Absent the new standalone moratorium, a UK scheme will generally be limited to offering flexibility to a company for achieving a balance sheet restructuring; it does not by itself provide the ability for a company to deal with operational issues that often are at the root of a company's financial difficulties. In contrast, the new UK restructuring Plan, coupled with a moratorium, will offer much greater flexibility and "operational" protection to companies.

A US chapter 11 bankruptcy case provides a company with an ability to address, in a plenary proceeding, both balance sheet and operational issues.

In a US chapter 11 case, although it is a bankruptcy proceeding, a key feature is that the debtor remains "in possession" of its businesses and operations, with the board continuing to have oversight of the company and management continuing to operate the company on a day-to-day basis. This is also true for UK schemes, UK restructuring Plans and companies in a UK standalone moratorium. Furthermore, immediately upon the commencement of such a case, an automatic stay is imposed. The automatic stay prohibits creditors and other parties from taking any action to obtain possession of property of the estate based upon a prepetition obligation, and stops the continuation or commencement of litigation against the debtor. As noted, a UK scheme or UK restructuring Plan by itself does not offer this protection, though the new UK standalone moratorium will provide significant protection against creditor action.

Chapter 11 cases also provide unique opportunities for debtors to access liquidity that otherwise would have been unavailable outside of chapter 11. The principal source of financing in corporate chapter 11 cases is debtor-in-possession (DIP) financing. DIP financing is bankruptcy court approved financing under which secured creditors are given the senior-most protection in the case, which can be in form of priming liens that come ahead of existing secured debt. Although a priming lien is an extremely powerful tool, it is not without limits. An important constraint is the ability to provide adequate protection to the existing secured creditors, which essentially means that the court has to believe that there is a reasonable expectation that the creditor being primed still will be able to recover out of the value of their collateral. Adequate protection can be simple with a first lien only deal, as long as the lender is over-secured, but it becomes much more complicated when there are second and third liens, such that the lowest lien is under-secured. To help eliminate the risk that a junior lienholder cannot receive adequate protection, intercreditor agreements frequently provide automatic consents by the junior lienholder to some amount of priming DIP financing capacity.

Under a UK restructuring Plan, it will be possible for a class of creditor that does not approve the Plan to be "crammed down" by the approvals of other classes, including

technically by a more junior class though this would depend on the court ruling that it is just and equitable to approve the Plan with this result. The conditions to this “cross-class cram down” (which lacks the priority rule under US Chapter 11 cram downs) are that the crammed down class is no worse off than it would have been under the “relevant alternative” (which is whatever the court decides is the most likely scenario if the Plan is not approved, *e.g.*, insolvent liquidation). In addition, the Plan must have been approved by one class that would receive payment under the relevant alternative.

In a US chapter 11 case, another significant tool is the power that debtors have with respect to executory contracts. Executory contracts are contracts, including leases, under which material performance is required by both sides. Once a debtor is in bankruptcy, the non-debtor party generally has to continue to perform under the contract—except for contracts to make a financial accommodation such as a loan or certain other safe harbored securities and derivative contracts—and cannot take advantage of “*ipso facto*” (bankruptcy or financial condition) termination clauses. In a chapter 11 case, the debtor has right to “assume,” “assume and assign” or “reject” its executory contracts. Assumption is a decision by the debtor to continue to live under the terms of contract during, and after, the conclusion of the bankruptcy case. Assumption requires the cure of prepetition monetary defaults and certain non-monetary defaults, and a showing of adequate assurance of future performance. If a lease is assumed it can be assigned to a third party, typically even if the contact had anti-assignment provisions in it. As an alternative to assumption, an executory contract can be rejected, which results in it being treated as having been breached immediately before the date of the filing of the petition, with all claims under the rejected contract being treated as prepetition unsecured claims.

Where a company initiates the UK restructuring Plan procedure or enters into a UK standalone moratorium, the new bar on the triggering of automatic or *ipso facto* termination clauses in its suppliers’ contracts will protect it against the loss of services and other supplies. This protection will not be available in the case of financial services (*e.g.*, loans) and, for a temporary period, in the case of “small suppliers.” The court will also be able to authorize termination where a supplier can demonstrate it would otherwise suffer “hardship.”

A chapter 11 case also gives the debtor the ability to sell assets free and clear of claims and liens either in conjunction with, or separate from, a plan of reorganization. Due to the fact that they are free and clear of claims and liens, bankruptcy sales (also referred to by the governing bankruptcy code provision as “363 Sales”) offer buyers significant protections that would not be available outside of bankruptcy. To obtain those protections, the debtor must prove that it obtained the “highest and best” offer, which typically involves an auction, together with some degree of subjective review of the merits of any bids received.

A company that is in a UK standalone moratorium will be allowed to dispose of assets subject to creditor security or financing with the permission of the court. The net proceeds received must be paid to the creditor and must be topped-up by any additional moneys that the court determines is necessary to produce the amount that

would have been realized on a sale of the property in the open market by a willing seller.

Summary

The COVID-19 crisis has led to a dramatic increase in corporate restructurings, and resulted in an unprecedented number of companies experiencing nearly overnight liquidity concerns. While the causes of liquidity concerns experienced by businesses may be new as a result of the pandemic, some of the basic tools to address them are not. However, in the UK three important new tools have been very recently introduced to address these difficulties, helping to move the approach of the UK insolvency and restructuring regime significantly closer towards the more debtor-friendly, rescue culture approach of the US.

It is often difficult to accomplish a comprehensive balance sheet restructuring without binding dissenting holders to the restructuring, which typically involves an in-court process. This paper outlines the two most common in-court regimes—a scheme of arrangement under English law and a chapter 11 case under US law—as well as the brand new (and as yet untested) UK restructuring Plan and considers the advantages and disadvantages of each.

Key considerations to be aware of relating to the two regimes:

- Positively, a UK scheme of arrangement (and now a UK restructuring Plan) under English law is accomplished under the UK Companies Act, which means it is generally not considered an insolvency proceeding, including for purposes of cross-defaults (depending on relevant draft), making it a very flexible tool for achieving a balance sheet restructuring with a relatively "light touch." Conversely, a UK scheme does not provide the ability for a company to deal with operational issues that often are at the root of a company's financial difficulties, although this disadvantage has now been significantly addressed by reforms contained in the UK Corporate Insolvency and Governance Act 2020.

- Advantages of a Chapter 11 case include:

  - the company has the ability to address both balance sheet and operational issues;
  - the debtor remains "in possession" of its businesses and operations, despite it being a bankruptcy proceeding;
  - it provides unique opportunities for debtors to access liquidity that otherwise would have been unavailable outside of chapter 11;
  - it gives power to debtors with respect to executory contracts; and
  - it gives the debtor the ability to sell assets free and clear of claims and liens, either in conjunction with, or separate from, a plan of reorganization.

- Advantages of the new UK restructuring Plan over a UK scheme include:

  - can be combined with the new UK standalone moratorium (as can a scheme);

- the cross-class cram down of creditors (or stockholders); and
- protection from the new bar on automatic termination clauses in supply contracts.

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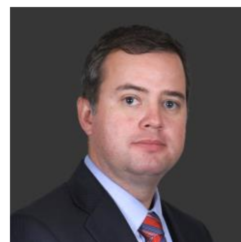

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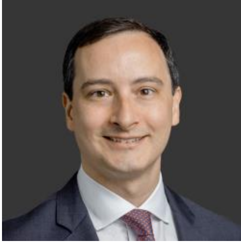

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