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COVID-19: Will Borrower Defaults Increase?

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On 11 March 2020, the Bank of England (the "**Bank**") warned of "an economic shock that could prove sharp and large" resulting from the coronavirus outbreak that started in Wuhan, China, at the end of 2019. Presenting a package designed to lower borrowing costs and improve the availability of finance, the Bank observed indicators of financial market uncertainty at "extreme levels", including sharp falls in risky asset and commodity prices, and all-time low government bond yields[1]. Today, the UK Government has also announced a broad-reaching package of financial measures to assist businesses, amounting to a reported total of £330bn, and has made clear that there are more policy options available as needed to prevent this temporary economic shock becoming a more permanent one.

The human cost of COVID-19 is still unfolding. In addition, the impact on businesses is inescapable. In particular, with COVID-19 impacting both demand and supply, many businesses are inevitably going to suffer disruption to their cashflows leading to an increased demand for short-term credit and, for those already borrowing, to a greater likelihood of defaulting on debt. For many borrowers this will outweigh the advantage of cheap financing options in a low interest-rate environment.

In a previous article, we considered the likelihood of material adverse change ('MAC') and force majeure clauses being engaged by the effects of COVID-19. In this article we will consider the position of the borrower who defaults on debt due to COVID-19. In particular, we will address how much discretion lenders have when enforcing against and selling assets pledged by the borrower as security; what role industry guidance has in governing how lenders act towards borrowers in these circumstances; and how borrowers should be approaching post- (or ideally pre-) default negotiations with their lenders.

Lender Discretion in Enforcing Security

In general, loan documentation will clearly set out the circumstances in which a lender can exercise its enforcement rights (generally when an event of default has occurred). There must be clear evidence that an event of default has occurred, and that any applicable grace period has elapsed without cure by the borrower. A mistaken allegation of default could have serious consequences for a borrower – for instance, potentially triggering cross-default provisions in each of the borrower's debt facilities. However, a borrower will generally have a remedy in damages against a lender who uses a wrongfully called event of default as grounds not to make further funds available to the borrower in breach of contract (*Mulvenna v Royal Bank of Scotland [2003] EWHC Civ 112*). There are also remedies (for instance, in the torts of trespass or conversion) for a borrower whose lender goes one step further and wrongfully enforces security.

Even where it has validly called an event of default, a lender's power to enforce against secured assets is not unfettered. A borrower is protected by the duties lenders have in exercising their power of sale over a secured asset, including the duty to act with reasonable care and skill (*Standard Chartered Bank Ltd v Walker [1982] 1 WLR 1410*), and the duty to obtain the best price reasonably obtainable for the asset (*Silven Properties Ltd v Royal Bank of Scotland [2003] EWCA Civ 1409*).

[1] The coronavirus crisis is evolving daily. This article is current to the best of our knowledge as of publication on 17 March 2020.

In particular, a charge-holder cannot simply "sell hastily at a knock-down price sufficient to pay off his debt" (*Palk v Mortgage Services Funding Plc [1993] Ch. 330*). On the other hand, the charge-holder has no general duty to postpone a sale in the hope of obtaining a better price (*Tse Kwong Lam v Wong Chit Sen [1983] 1 WLR 1349*), meaning that this protection is not a 'silver bullet' for borrowers. In more extreme cases, a lender who is deemed to be acting as a shadow director of a borrower under s170(5) Companies Act 2006 (for example, where the lender acts through representatives on the company's board) may owe additional duties to the company in such capacity as shadow director (*Standish v Royal Bank of Scotland [2019] EWHC 3116 (Ch)*).

High levels of borrower defaults naturally coincide with declines in financial indices and asset prices. As such, many assets pledged as security will have lost a significant part of their value by the time lenders come to enforce debt claims against the assets. Lenders may therefore not be maximising their own recovery potential by exercising their right to sell the relevant assets immediately. If financial and asset markets continue to drop in light of coronavirus concerns as we have seen in the past several weeks, lenders may find themselves selling secured assets into markets which do not want to purchase them, meaning that prices will drop accordingly. Whether this will constitute a breach of their duties as charge-holders will depend on the facts of each case, but it would certainly be a relevant point for borrowers to make when negotiating with their lenders.

Finance Industry Guidance

Some finance industry members have already announced measures to address coronavirus-related defaults. For example, Lloyds announced on 10 March 2020 that it would make available £2 billion of funding, in fee-free finance and payment holidays for UK SMEs hit by the coronavirus. Italy's banking association (the Associazione Bancaria Italiana) has also announced that its lenders will be offering debt moratoria to affected households and small firms. In the governmental sphere, France and Germany's governments have announced hundreds of billions of euros in financial support for businesses, as well as the UK's (as noted above).

UK financial regulators too have stepped up to the debate. As already noted, the Bank of England last week announced a package of measures intended to secure access to financing for struggling businesses, including a 50-basis point drop in its base rate and the creation of a new Term Funding Scheme. The Scheme will allow for extra funding for those banks that increase lending, especially to SMEs. At the same time, the Prudential Regulation Authority (the "**PRA**") made clear that banks should not increase dividends or other distributions, such as bonuses, in response to these policy actions, but should channel the benefits entirely to their customers.

However, many corporate lenders are not regulated by the PRA, among them hedge funds and other non-bank lenders, and increasingly distressed debt investors who could purchase large quantities of coronavirus-affected debt. Moreover, the Financial Conduct Authority ("**FCA**") and PRA have not yet gone so far as to specifically advise lender caution in enforcing debt against those borrowers temporarily affected by the coronavirus pandemic. Central banks and regulators may begin to do so in the coming weeks and months, and indeed industry bodies have called for government edicts requiring banks temporarily not to enforce financial performance-based banking covenants. Until then though, it seems that the greatest incentive lenders have towards leniency could be the reputational threat of being seen to capitalise on the crisis.

Approaching Lender Negotiations

While nothing is certain yet in this evolving crisis, businesses the world over must hope for two things: that the worst of it is over quickly; and that it does not affect their underlying profitability, or lenders'

perception of the same. Assuming the latter, it is likely that regulators will expect lenders at least somewhat to assist borrowers affected by the coronavirus where possible. Moreover, if the crisis does prove to be relatively short-lived, it should be easy for borrowers to show lenders that they would benefit more from offering a short payment holiday – and eventually being paid in full – than from attempting to sell secured assets into a market currently falling dramatically.

Borrowers in the syndicated loan market may have multiple different lenders to deal with for each loan. In approaching negotiations, borrowers will therefore have to consider the differing incentives driving each lender. These incentives will depend particularly on the lender's place in the borrower's capital structure. For instance, while senior lenders hold the bulk of the offered security (and will therefore be better off than others in a default situation), mezzanine lenders hold less security. They will therefore generally prefer to prevent a default situation where possible and maintain their flow of higher interest payments from the debt. Any lenders with a quasi-equity interest will be even less reluctant to call a default, as they will be the last to get paid in a default or insolvency scenario.

While this could complicate negotiations somewhat, many financing arrangements include majority voting provisions, meaning that a borrower will generally not be sunk by a single aggressive lender refusing to give a waiver of default. Some borrowers with strong bargaining positions may even have negotiated a right to replace syndicate members when they choose to.

Affected borrowers may also want to consider how they can leverage the support of peer firms and industry bodies. Although a mass legal claim against security-enforcing lenders seems unlikely in the English courts, industry bodies such as the Confederation of British Industry have begun to publish resources for companies affected by the coronavirus, and will be useful as vocal advocates for business in the trying times ahead.

In general, borrowers should not panic unduly in the face of faltering cashflows resulting from the dampening effects of the coronavirus. Proactive approaches to lenders will be advisable in many cases. Otherwise, there is likely to be plenty of other assistance available from governments and other sources in navigating what the world hopes to be a short-term challenge only.

Borrowers should review their financing agreements as soon as possible, ideally with the assistance of legal advisors, when they perceive that there is a risk of defaulting on those agreements. Timely action is paramount in this context. If addressed early enough, borrowers will be approaching lenders in a restructuring context (requesting for instance, a period of interest-only repayments or an extension of the debt's maturity) rather than in a default context. The former is far less likely to trigger cross-default provisions in a borrower's other finance documentation. It will also significantly reduce the time, cost, and effort required by all parties at a time when energies are better off being directed elsewhere.

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