

Derivative considerations for end-users in times of disruption

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The coronavirus COVID-19 is causing disruption across many business contexts and it would be prudent to do a check of your contractual obligations to determine if there are any consequences of the current disruption. While this should be done across contracts, including loan agreements, bond documents and other type of finance and commercial agreements, this note is intended to provide a short checklist for review of your derivatives agreements in this time of stress. The good news is that the experience with derivatives documentation during the financial crisis in 2008 and Lehman insolvency tested many of these provisions so the marketplace has more certainty as to how to interpret these provisions in the time of stress than we did in 2008.

What should we be doing now?

Companies should begin reviewing their ISDA Master Agreements, Schedules to ISDA Master Agreements, Confirmations, credit support arrangements (collectively, "ISDA Agreements") or similar derivatives contracts to evaluate the suspension, disruption, credit support posting or termination provisions in the context of unfolding events. In particular, end-users should begin to consider the following questions below:

Is COVID-19 a force majeure or similar event?

- Section 5(b)(ii) of the 2002 ISDA Master Agreement is a Force Majeure Event Termination Event, which permits parties to suspend performance for a period of time and then ultimately terminate.
- While the 1992 ISDA Master Agreement does not contain a force majeure provision in its boilerplate, parties may have agreed to include in the Schedule a force majeure provision that is identical or similar to Section 5(b)(ii) of the 2002 ISDA Master Agreement.

The determination of whether the COVID-19 is a force majeure event is a fact specific determination and depends upon the asset class, whether there is physical delivery and other factors. It should be noted that a cash shortfall as a result of market conditions due to the COVID-19 is unlikely to be a force majeure event; rather, the event must itself prevent or make performance impossible or impractical, not uneconomical.

Does the ISDA Agreement or similar agreement provide for termination upon a ratings downgrade or another additional termination event which would allow your counterparty to terminate?

- Parties to an ISDA Agreement may specify in the Schedule or Confirmation that an Additional Termination Event applies if either one or both parties are downgraded below a certain ratings threshold by one or more ratings agency.
- Parties may have also negotiated bespoke termination events which may be relevant in the time of distress, including NAV triggers and other similar events.

Is there a material adverse effect clause?

- While the boilerplate to the ISDA Agreement does not have a material adverse effect clause (MAE clause), parties may have elected to include an MAE clause in the Schedule or Confirmation which would allow for termination of the ISDA Agreement or a suspension of payment.
- If your derivatives agreement contains an MAE clause, you should understand whether it is triggered by reference to objective standards or whether there is some degree of discretion that one or more party may use in declaring that a material adverse effect has occurred.

Derivatives Cross-Defaults

Even if any force majeure provision in your derivatives agreement is not likely to be triggered and there is not a ratings downgrade or MAE clause in the ISDA Agreement, these events could be a default under a linked financing agreement such as the loan agreement hedged by the derivative, and therefore the cross-default provisions of the ISDA Agreement could be implicated and should be reviewed.

- Section 5(a)(vi) of both the 1992 and 2002 ISDA Master Agreement is an elective Event of Default that provides for cross-default if there is default on "Specified Indebtedness" above a "Threshold Amount."
- Have the parties specified in the ISDA Schedule that Section 5(a)(vi) applies?
- If Section 5(a)(vi) applies, check to see if Section 5(a)(vi) of the ISDA Agreement has been changed to cross-acceleration and how the terms "Specified Indebtedness" and "Threshold Amount" are defined.
- Even if the ISDA Agreement does not contain a cross-default provision, there may be an Additional Termination Event or Additional Event of Default that permits the dealer to terminate upon a default under a specified financing document.

Market disruption and trading disruption

Many ISDA Agreements contain valuations that are based upon market price sources (for example, in relation to an equity derivative). If such sources are not published or trading in the underlying asset is suspended, this could affect calculations of mark-to-market, option value and settlement amounts.

- Suspension of trading on stock exchanges, supply chain disruptions and closing of trading floors could require postponement of valuations, change in calculation methodology or in certain cases early termination.
- Many ISDA Agreements incorporate by reference the definitions and disruption events for the specific assets underlying the transaction, such as the 2002 ISDA Equity Derivatives Definitions or the 2005 ISDA Commodities Derivatives Definitions.

- These definitional booklets published by ISDA have various disruption provisions and fallbacks that should be consulted to determine the effects of trading suspensions, closing and other events that could affect the price source and valuations.

Could additional credit support/collateral/guaranty obligations be triggered?

- Where the ISDA Agreement or similar provides a termination right linked to a ratings downgrade, it is possible that the downgraded party may cure by posting collateral or providing a guarantee within a specified time period.
- If the parties are already exchanging collateral pursuant to an ISDA Credit Support Annex or similar agreement, a credit downgrade may result in the downgraded party having to post additional collateral, either in the form of an "Independent Amount" or by virtue of a reduced "Threshold."
- In relation to cleared derivatives, it is important to check the terms on which collateral calls can be made and the extent to which you can rely on any clearing member that you use to access central clearing counterparties.

Are the terms of your derivatives agreements consistent?

- Derivatives documentation is heavily negotiated so it is likely that agreements with different dealers will not have identical termination or collateral provisions.
- Similarly, not all entities in your corporate group may have the same terms in their derivatives agreements, even when trading with the same dealer. Check whether a default by one entity in your corporate group allows the dealer counterparty to terminate transactions with other entities in your corporate group.

Contacts



Evan Koster
Partner, New York
T +1 212 918 8260
evan.koster@hoganlovells.com



Adam Lapidus
Senior Associate, New York
T +1 212 918 3246
adam.lapidus@hoganlovells.com

www.hoganlovells.com

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