Impact of Covid-19: What Issuers and Underwriters in the Debt Capital Markets Space Should Know

Debolina Saha- Presenter

David Cameron, Kenneth Kwok

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  b) **Underwriters.**
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The Unleashing of the Global Pandemic
An Introduction

-**April 12, 2020**: **World Bank** said that coronavirus outbreak has **"severely disrupted"** the Indian economy. In its South Asia Economic Update: Impact of Covid-19, the World Bank estimated the Indian economy to **decelerate to 5% in 2020 and projected a sharp growth deceleration in fiscal 2021 to 2.8% in a baseline scenario**.

-A **FICCI** survey showed **53%** of Indian businesses have indicated a marked impact of COVID-19 on business operations.

-**S&P Global Ratings** slashed India's fiscal 2021 growth forecast to **3.5%, India Ratings & Research** to 3.6%, **Moody's Investor Service's** to **2.5%** and **Fitch** to **2%**. Since economic liberalization in 1990's these are the lowest growth figures India has witnessed!

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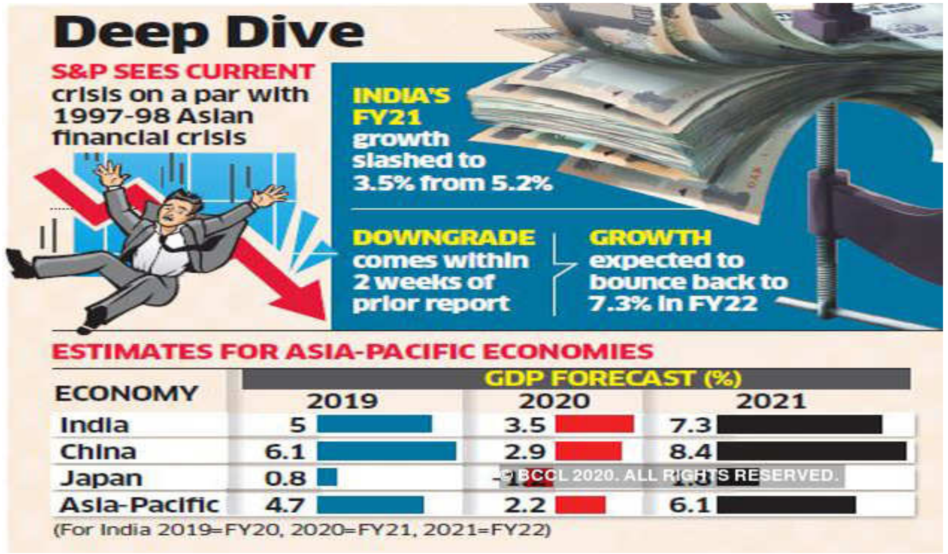
The Unleashing of the Global Pandemic
An Introduction

China's share in total imports to India

Organic chemicals	37%
Inorganic chemicals	13%
Medicinal & Pharma products	36%
Dyes	28%

Source: https://commerce.gov.in



Source-Deep Dive

-Stock Markets in India posted their **worst losses** in history on 23 March 2020. SENSEX fell 4,000 points. The complete shutdown in India due to Covid-19 is expected to cost a loss of over **USD120 billion** to the economy. The situation is **more grave** than the 2008 financial crisis!

-The **International Monetary Fund** predicted the "Great Lockdown" would spark the **worst global downturn since the Great Depression of the 1930s**.

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PART I

For Issuer's Attention

Impact of Covid-19 on Issuers

-Indeed an interesting time to raise capital

-Issuers would need to **monitor contractual obligations** more closely, specifically those around **force majeure** and **material adverse clauses (MAC)**

- More thought would need to be given to **disclosure requirements, due diligence process**, **continuing obligations, additional compliance that may be required by new legislations, financial reporting obligations, corporate governance issues etc.**

What Issuers Need to Pay Attention To (1)

Contractual Obligations: Force Majeure and Doctrine of Frustration

<u>**Force Majeure**</u>

- "superior force" and it has its origins in French civil law. **English law**- no doctrine of force majeure.

The four key questions that the Issuer should ponder over would be:

- If *force majeure* clause has been drafted to include the interpretation of COVID-19 within it?;
- Whether such an act has prevented, hindered or delayed the underwriters from performing the obligations that such underwriters owed to the issuer?;
- Whether the non-performance was due to circumstances outside of the control of the underwriters?; and
- Whether there were no reasonable steps that the underwriters could have taken to avoid or mitigate against the event?

- If answer to all the above is "**yes**", then the underwriters <u>**can exercise**</u> the force majeure clause of the agreement.

What Issuers Need to Pay Attention To (2)

Contractual Obligations: Force Majeure and Doctrine of Frustration

Force Majeure

- Key question should be "Whether Covid-19 has made the performance of the obligation **impossible**?"
- Under English law performance becoming **more burdensome** is **no excuse**
- Important to **identify** the **risks** and **consequences** of the default

- In debt capital markets transactions which are governed by English law, the force majeure clause is drafted as part of the "termination clause" in favor of the underwriters in the program agreement or subscription agreement (as the case may be).

What Issuers Need to Pay Attention To (3)

Force Majeure in Debt Capital Markets Transactions**

- Underwriting agreements in **US offerings** also routinely contain force majeure and termination clauses permitting the underwriters to **terminate their obligations under the underwriting agreement if, in their judgement, there has been a sharp downturn in market conditions or deterioration of the financial condition or business of the issuer between the signing of the underwriting agreement and the scheduled closing of the offering such that consummating the offering would be impracticable**.

- Typical force majeure clauses also extend **to the occurrence of natural disasters or calamities, such as an outbreak of hostilities or suspension of trading in the United States or, in certain cases, non-US securities markets**.

** (*Source-Lexology.com*)

Sample of a Force Majeure Clause

- “The **Lead Manager, on behalf of the Managers, may, by notice to the Issuer, terminate this Agreement at any time prior to payment of the net purchase money to the Issuer** if in the opinion of the Lead Manager there shall have been such a change, whether or not foreseeable at the date of the Agreement, **in national or international financial, political or economic conditions or currency exchange rates or exchange controls as would in its view be likely to prejudice materially the success of the offering and distribution of the Notes or dealings in the Notes in the secondary market and, upon notice being given, the parties to this Agreement shall……………..** be **released and discharged** from their respective obligations under this Agreement”. [*Based on the ICMA standard clause*]

- Specificity would necessitate that there is **actual mention of the name of the pandemic** as well as **general references to all kinds of pandemic being covered under this clause**.

What Issuers Need to Pay Attention To (4)

<u>Force Majeure in Debt Capital Markets Transactions **</u>

- Underwriters tend to view the unilateral right to declare a force majeure event and to terminate as a fundamental protection provided to them in the underwriting agreement.
- Nonetheless, force majeure clauses in **US offerings are rarely exercised by the underwriters**, principally because of the **limited period of time between the signing of the underwriting agreement and the closing of the offering (typically two business days)** and the potential reputational harm associated with an underwriter's exercise of such clauses.
- **Doctrine of Frustration**- Under English law a contract will terminate automatically when a frustrating event occurs **<u>after the entering of the contract</u>**, i.e., one which is: (1) **unexpected**; (2) **beyond the parties' control**; and (3) which makes **performance impossible or radically different** from that which the parties contemplated at the time of entering into the contract.
- Given that COVID-19 is currently an ongoing event, Issuers may want to **<u>raise the bar of materiality of the impact of Covid-19</u>** than what it is as of today for triggering the termination provision.

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** (*Source-Lexology.com*)

What Issuers Need to Pay Attention To (5)

<u>Material Adverse Clause in Debt Capital Markets Transactions</u>

- Given that COVID-19 is currently an ongoing event, the adverse effects of the pandemic would have already been disclosed in the Offering Circular and appropriate representations which are generally provided for by the Issuer in an underwriting agreement/ program or subscription agreement would already have been provided by the Issuer against the benchmark of disclosure in the Offering Circular

- A **MAC clause** only covers for situations where **new development** has taken place that was **previously not disclosed for in the Offering Circular**. Therefore it is **unlikely** that the underwriters can avail of the MAC provision between the signing and closing period.

- <u>Others</u>

  - **Definition of Business Days** and **Notice Periods** would need to be carefully negotiated

  - Check for validity of **consents**

What Issuers Need to Pay Attention To (6)

Disclosure Requirements

- **(i) Risk Factors (ii) Recent Developments (iii) Business (iv) MD&A**
- **"Risk Factors"/ "Investment Consideration"** chapter of the Offering Circular would need to **clearly lay out the effect of the uncertain and unpredictable adverse impact of COVID-19**; Generic risk factor on pandemic may be insufficient
- SEC guidance which can be found at https://www.sec.gov/corpfin/coronavirus-covid-19
  - Is the Issuer's cost of or access to capital and funding sources, such as revolving credit facilities or other sources, likely to change?
  - Is there a material uncertainty about the Issuer's ongoing ability to meet the covenants of its credit agreements?
  - Does the Issuer expect to incur any material COVID-19-related contingencies?
  - Does the Issuer anticipate any material impairments (e.g., with respect to goodwill, intangible assets, long-lived assets, right of use assets, investment securities), increases in allowances for credit losses, restructuring charges, other expenses, or changes in accounting judgments that are reasonably likely to have a material impact on the Issuer's financial statements?
  - Has the Issuer experienced challenges in implementing its business continuity plans or foresees itself requiring material expenditures to do so? Does the Issuer face any material resource constraints in implementing these plans?
  - Does the Issuer expect COVID-19 to materially affect the demand for its products or services?

What Issuers Need to Pay Attention To (7)

Disclosure Requirements-Recent Developments

- **Recent Developments-**Given COVID-19 is a recent development, Issuers wanting to go for a drawdown under a previously updated MTN Offering Circular may want to **include a "Recent Developments" section on COVID-19 in the Supplemental Note Offering Circular highlighting the impact of the virus on the industry/ business as well as the steps the Issuer already has in place to counter the virus along with additional steps that the Issuer is currently implementing to limit the damage both in the near short term as well long term**

- **Business Section**-Issuers would need to **clearly detail the impact of COVID-19 on its business and industry** especially if the Issuer's business operations are conducted in regions that have been heavily affected by COVID-19 or the Issuer is involved in real estate development, tourism and entertainment, transportation, manufacturing or other sectors that have been heavily impacted by COVID-19.

- **SEC recommends that some of the questions to consider would be:**

- Does the Issuer anticipate a material adverse impact of COVID-19 on its supply chain or the methods used to distribute the Issuer's products or services? Does the Issuer expect the anticipated impact of COVID-19 to materially change the relationship between costs and revenues?

- Will the Issuer's operations be materially impacted by any constraints or other impacts on its human capital resources and productivity?

- Are travel restrictions and border closures expected to have a material impact on the Issuer's ability to operate and achieve your business goals?

What Issuers Need to Pay Attention To (8)

Disclosure Requirements-MD&A

Management's Discussion and Analysis- Issuer would need to discuss, an analysis of trends or expected fluctuations in the **company's liquidity and capital resources, an analysis of any defaults or arrears, or significant risk thereof, on the company's ability to make key payments and its ability to satisfy its debt covenants, a discussion of how the company intends to address any actual or potential default, and the expected source of funds to meet the company's capital expenditure commitments.**

The SEC guidance provides the following questions, as indicators of what may be included in this chapter:

- How has COVID-19 impacted the Issuer's financial condition and results of operations? In light of changing trends and the overall economic outlook, how do the Issuer expect COVID-19 to impact its future operating results and near- and long-term financial condition? Does the Issuer expect that COVID-19 will impact future operations differently than how it affected the current period?

- How has COVID-19 impacted the Issuer's capital and financial resources, including its overall liquidity position and outlook? Has the Issuer's cost of or access to capital and funding sources, such as revolving credit facilities or other sources changed? Has the Issuer's sources or uses of cash otherwise been materially impacted? If a material liquidity deficiency has been identified, what course of action has the Issuer taken or proposed to take to remedy the deficiency?

What Issuers Need to Pay Attention To (9)

Disclosure Requirements

MD&A and SEC guidance continued….

- Issuer to consider the requirement to disclose known trends and uncertainties as it relates to its ability to service its debt or other financial obligations, access the debt markets, including commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral, and counterparty or customer risk.

- How does the Issuer expect COVID-19 to affect assets on its balance sheet and its ability to timely account for those assets? For example, will there be significant changes in judgments in determining the fair-value of assets?

- Has COVID-19-related circumstances such as remote work arrangements adversely affected the Issuer's ability to maintain operations, including financial reporting systems, internal control over financial reporting and disclosure controls and procedures? If so, what changes in the Issuer's controls have occurred during the current period that materially affect or are reasonably likely to materially affect the Issuer's internal control over financial reporting? What challenges does the Issuer anticipate in its ability to maintain these systems and controls?

- **Critical Accounting Estimate and Forward Looking Statements**

What Issuers Need to Pay Attention To (10)

Due Diligence

- Given the travel ban and lock-down in many countries, Issuers would need to ensure that **online data rooms** are created for purposes of documentary due diligence; this may involve **additional expense** and be **cumbersome** to Issuers that have been long established or do not have adequate infrastructure to organise such online platforms
- In case the Issuer has any business connection to China or any of the majorly affected COVID-19 places, the Issuer should be prepared to answer due diligence queries on the **size** of the Issuer's business in such regions, the **status** of operations, the **impact** and **degree of disruption** to business due to COVID-19, the Issuer's current **cash-flow** status and impact of COVID-19 on the **upcoming financials** of the Issuer
- The Issuer should also be prepared to answer **steps it has undertaken including investments and capital expenditure to mitigate the damage** caused by COVID-19

What Issuers Need to Pay Attention To (11)

Continuing Obligations

- Where the Issuer has already been listed and is under an obligation to pay out the principal and interest amount but due to the impact of COVID-19 is unable to, the Issuer would then need to conduct **liability management exercises to restructure its debt (exchange old bonds, consent solicitation etc.)**

- Issuer would need to determine whether any developments have taken place that would have a bearing on the investment decisions of investors or be considered inside information or become an ongoing trend and accordingly comply with its various obligations (where applicable) under the **Securities Exchange Act, the Listing Rules, the Transparency Rules, the Market Abuse Regulation, The Financial Conduct Authority's Disclosure Guidance and Transparency Rules and the London Stock Exchanges Admission and Disclosure Standards**

- SEBI has also **extended the due date for regulatory filings and compliances** for real estate investment trusts and infrastructure investment trusts for the period ending 31 March 2020 by one (1) month over and above the timelines prescribed under SEBI (Infrastructure Investment Trusts) Regulations, 2014 (InvIT Regulations) and SEBI (Real Estate Investment Trusts) Regulations, 2014 (REIT Regulations) and circulars issued thereunder.

What Issuers Need to Pay Attention To (12)

Financial Reporting Obligations

- The Issuer would need to beef up disclosure relating to subsequent developments due to COVID-19 in the Notes To Financial Statement section.
- Dissipation of relevant information would need to be **holistic** and **not selective**
- In India the **Securities and Exchange Board of India (SEBI)** has granted an **extension of forty five (45) days** to listed entities in filing quarterly financial results. In respect of annual financial results, SEBI has extended the due date of filings by one (1) month i.e. up **to 30 June 2020**.

What Issuers Need to Pay Attention To (13)

Corporate Governance Obligations

- Due to restrictions on assembling and travel, holding of annual general meetings or board meetings may be difficult to conduct.
- Similar to the **Singapore Stock Exchange** which has allowed companies an extension until 30 June 2020 for holding of annual general meetings approving the December 31, 2019 results, the **Ministry of Corporate Affairs** in **India (MCA)** has with certain exceptions generally allowed all the companies to take decisions of urgent nature, requiring the approval of members/ shareholders of the company, **without holding a general meeting requiring physical presence of members at a common place**
- The MCA has also amended provisions to to provide that all the matters which earlier required physical presence of directors at a board meeting **can now be approved at a board meeting held through video conferencing or other audio visual means till June 30, 2020**.

PART II

For Underwriters' Attention

What Do Underwriters' Need to Understand?

- Underwriters have a **right to termination** under the subscription agreement

- **Scope of diligence** needs to be **correctly assessed** and conveyed to the **Issuer** and **Auditors upfront** at the beginning of the transaction itself

- Underwriters would need to ask **relevant and meaningful questions in the various due diligence sessions** to bring to the forefront the appropriate risk factors to investors

- **Logistical issues** regarding **road-shows** to be discussed upfront; possible solutions could be net **road-shows** and **investor conference calls with appropriate built-in measures to prevent certain investor group from being present in such road-shows**

- **Issuer** should be apprised that **physical signing of documents may not be possible**; also various parties who generally require **originals documents** as part of their in-house requirements **may need to be requested to suffice with scanned copies**

The Lessons Learnt and Way Forward

- Guard **against Insider Trading** and **Selective Disclosure**
- Full disclosure on impact of COVID-19 on demand, sales, manufacturing, operations, employees
- Good time to review the **all prior disclosure** in the Offering Circular
- Better to use terms such as “we believe” and others that denote opinion, more generously
- **Financial reporting** and **auditing and reviewing processes** are as **robust** as can be

Contact Information

David Cameron

Partner

10+ years focusing on India transactions

US and Hong Kong qualified

Kenneth Kwok

Partner

15+ years focusing on India transactions

US qualified

Debolina Saha

Senior Associate

10+ years focusing on India transactions

UK and India qualified

Speaks Bengali, Hindi and Nepali

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Questions