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COVID-19: Waivers of defaults under finance agreements

Richard Salter QC, Andrew Fletcher QC and William Day consider some of the issues which are likely to arise following defaults under finance agreements during the current pandemic.

As the COVID-19 crisis wears on, the risk of resulting default under commercial loans grows. This raises the spectre of repayment accelerations and cross-defaults, potentially leading to a vicious circle of default and instability in global credit markets. Lenders will be asked by borrowers to consider waiving their rights on breach or exercising other forbearance. Further, in the litigation that follows the pandemic, creditors will find debtors frequently raising waiver defences to resist enforcement action. However, the law of waiver is not straightforward and its interaction with agreed formalities typically found in finance agreements is far from clear. This note flags difficulties which may confront both lenders and borrowers.

Three days after the Prime Minister announced the current lockdown, on 26 March 2020, the CEO of the PRA sent regulated firms a letter (endorsed on the same day in a joint statement from the PRA, the FCA and the FRC) saying:

> "Lenders and other users of financial statements are urged to consider carefully their responses to potential breaches of covenants arising directly from the COVID-19 pandemic and its consequences. Where those uncertainties are of a general nature or are firm-specific but unrelated to the solvency or liquidity of the borrower, we would expect lenders to consider the need to treat them differently compared to uncertainties that arise because of borrower-specific issues and in doing so consider waiving the resultant covenant breach. We would expect firms to do so in good faith and not to impose new charges or restrictions on customers following a covenant breach that are unrelated to the facts and circumstances that led to that breach."

There is, however, no general duty of good faith in English contract law: see, e.g., *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd (t/a Medirest)* [2013] EWCA Civ 200 [105] (Jackson LJ). Moreover, despite the recent calls of Lords Neuberger and Phillips (see here), the proposed UK legislative response seems to be insolvency-focused and does not presently seem likely to include provisions excusing parties from performance if their failure has been caused by COVID-19. That is to be contrasted with Singapore, where the COVID-19 (Temporary Measures) Act 2020 includes provisions applicable to certain contracts (including performance bonds and loan or finance contracts secured on premises or plant in Singapore where the borrower has a turnover of more than SGD 100 million, carries on business in Singapore and is at least 30% Singapore-owned) which prohibit certain actions from being taken against counterparties or their guarantors if the inability of the counterparty to perform such contracts is to a material extent caused by COVID-19.

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In any event, even applying the PRA guidance, in many cases it may be difficult to clearly distinguish between a COVID-19 caused breach and a borrower-specific breach. Many defaults are likely to result from a combination of the two. Borrowers in financial difficulty but compliant with loan covenants prior to the spread of coronavirus are more likely to breach their obligations than those who had been in better shape before the start of the crisis.

Nonetheless, in the face of this regulatory guidance, and given public opinion, financial institutions are likely to be cautious about seeking to accelerate loans or enforce security immediately on breach in the current climate. That caution is sensible and understandable. However, it means that, in the likely wave of banking and finance litigation following the pandemic, we can expect to see a trend of borrowers claiming that this restraint by lenders amounted to a binding waiver of breaches for which they would otherwise have no valid legal excuse.

Party agreed formalities

Lenders are familiar with waiver defences and have sought to limit their availability in the boilerplate of financial documentation. For example, the Loan Market Association ('LMA') standard wording provides:

> "
> **Remedies and Waivers**
>
> No failure to exercise, nor any delay in exercising, on the part of any Finance Party, any right or remedy under a Finance Document shall operate as a waiver of any such right or remedy or constitute an election to affirm any of the Finance Documents. No election to affirm any Finance Document on the part of any Finance Party shall be effective unless it is in writing. …
>
> **Required consents**
>
> … any term of the Finance Documents may be amended or waived only with the consent of the Majority Lenders and the Obligors and any such amendment or waiver will be binding on all Parties.
> "

Two important questions will need to be considered in any dispute (or to mitigate the risk of any dispute). First, what is waiver, and what is its effect? Second, can waiver be restricted in this way by prior party agreement?

Waiver is not a single doctrine

Waiver was famously described as a *"word used indefinitely as a cover for vague, uncertain thought"*: JS Ewart, Waiver Distributed (HUP, 1917) 5. It is best understood as a portmanteau term which covers a number of different doctrines, which all have the same functional effect of depriving a claimant of a remedy which they would otherwise have. In *The Kanchenjunga* [1990] 1 Lloyd's Rep 391, 397–399, Lord Goff identified (in the context of charter parties) three interrelated concepts that are spoken of in the context of waiver: forbearance, election and estoppel. Each of these operates differently, so should be considered separately. As we also explain below, the effectiveness of party-agreed formality requirements such as "no oral waiver" clauses are likely to differ as between these three concepts.

Forbearance

Forbearance arises where one party breaches, or is about to breach, a contractual obligation, and the innocent party decides not to exercise its remedies (or some of them) in respect of the breach. As Lord Atkinson put it in *Morris v Baron* [1918] AC 1 (HL) 17, speaking of what might be termed unilateral forbearance, *"the contract is not varied at all, but the mode and manner of its performance is … altered."* Forbearance of this kind is the gratuitous act of the innocent party. It will not normally prevent the innocent party thereafter from enforcing rights arising on breach on the giving of reasonable notice, unless (and to the extent) that it (1) amounts to an election to affirm the contract or (2) gives rise to an estoppel.

Contractual forbearance, by contrast takes effect as a binding variation of the contract, where, in response to actual or contemplated breach, the parties agree to adjust their contractual obligations. Like any other variation of contract, it requires consideration (or a deed) to be binding.

Forbearance, being consensual, can take place before breach (sometimes called "pure waiver") or after breach (sometimes called "total waiver") – but neither label is illuminating. The forbearance can relate to one, some, or all remedies, depending on its terms. Forbearance to exercise one remedy (for example acceleration) will not preclude exercise of another (for example levying default interest). It can be permanent, or revocable on reasonable notice. The scope of forbearance should be determined in the usual way by asking how a reasonable person in the position of the parties would understand the parties' intentions bearing in mind the language and conduct of the parties and the factual matrix of the case: *Ogle v Earl Vane* (1866-67) LR 2 QB 275 (QB) 282 (Blackburn J).

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It would therefore be prudent for parties negotiating a forbearance agreement to ensure compliance with stipulated formality requirements for modifications and waivers in finance documentation.

In *MWB Business Exchange Ltd v Rock Advertising Ltd* [2018] UKSC 24, [2019] AC 119, the Supreme Court held that (absent estoppel) a "no oral modification clause" was effective according to its terms to preclude a later, orally agreed variation, even where consideration was present. That is because, by its nature, the first contractual provision restricts the parties' autonomy thereafter, such that the earlier agreement prevails over an inconsistent later variation. The courts have since recognised that this reasoning applies by analogy to gratuitous agreements to forbear from suing: see, e.g., *GPP Big Field LLP v Solar EPC Solutions SL* [2018] EWHC 2866 (Comm) [203.3] and *Sumitomo Mitsui Banking Corporation Europe Ltd v Euler Hermes Europe SA* [2019] EWHC 2250 (Comm) [64]. The estoppel exception is narrowly construed: see J O'Sullivan, 'Party-agreed formalities for contractual variation – a rock of sense in the Supreme Court?' (2019) 135 LQR 1, and *Kabab-Ji S.A.L. (Lebanon) v Kout Food Group (Kuwait)* [2020] EWCA Civ 6 [71]–[81] (Flaux LJ). Accordingly, unless, as Butcher J put it in Sumitomo [56], there was in the terms if the waiver relied on *"something which indicated that the waiver was effective notwithstanding its noncompliance with the non-waiver clause … something more ... than what might otherwise simply constitute a waiver of the original right itself"*, wording such as that in the LMA standard form quoted above would likely be effective to forestall a defence based on a non-compliant forbearance agreement.

It would therefore be prudent for parties negotiating a forbearance agreement to ensure compliance with stipulated formality requirements for modifications and waivers in finance documentation. The terms of forbearance agreements will obviously be a matter for detailed negotiation, but the PRA's recent guidance should assist borrowers, discourage lenders from using the threat of default as a lever to ramp up protection disproportionately, and also provide lenders some room for manoeuvre in satisfying the requirements of IFRS9, so easing pressure on their own balance sheets.

A forbearance agreement, as part of a strategy of full evaluation, proper disclosure and good communication should help borrowers and lenders to achieve the best outcome possible in these difficult circumstances. It will also limit the risk of later argument as to whether, and to what extent, some less formal waiver or forbearance may, unwittingly, have affected the parties' rights, for example by a wider implied agreement or estoppel; and for potentially complex arguments as to whether there has or has not been an election to affirm.

Election

Election arises where, following a breach of contract, the law presents the innocent party with two mutually exclusive options. In the face of repudiatory breach, for example, a contract can be affirmed or terminated. Similarly, in the face of a vitiating factor such as misrepresentation, duress or undue influence, a contract can be affirmed or rescinded. Election in these cases arises because the law gives the innocent party a choice of "self-help" remedies.

Election as described above is a creature of common law. However, party-agreed rights of termination are almost ubiquitous in finance agreements, allowing the lender on many (not just repudiatory) breaches, to choose, for example, to accelerate the schedule of loan repayments and bring the line of credit to a premature end. The choice whether to accelerate may be analysed as an election, such that if the lender takes too long to decide whether or not to accelerate the loan, the law might take the choice out of the lender's hands and treat the loan agreement as having been affirmed.

In *Tele2 International Card Co SA v Post Office Ltd* [2009] EWCA Civ 9, the Court of Appeal doubted whether a basic no-oral waiver clause would extend to questions of election. However, even assuming it did, the Court of Appeal held that it would have had no effect for two reasons: (i) it could not *"prevent the fact of an election to abandon the right to terminate from existing"* and (ii) *"the general law demands that a party which has a contractual right to terminate a contract must elect whether or not to do so"* (at [56]). See also, in similar terms, *R v Paulson* [1921] 1 AC 271 (PC). There seems room for argument as to whether this principal of the general law is engaged by an option to accelerate; and it is certainly difficult to see that it could be engaged by less radical remedies, such as the imposition of default interest.

It remains to be seen whether these cases will be reconsidered after the Supreme Court's decision in *MWB* (above). It might well be argued that a distinction should be drawn between an election to affirm or rescind at common law and an election to invoke a contractual remedy becoming available on breach. At common law, it is trite that a party cannot simultaneously "approbate and reprobate": cannot, at the same time, claim that a contract has been discharged for breach and also must be performed. However, a contractual acceleration or termination right is exercisable according to its terms. If those terms provide (as in the case of the LMA standard form quoted above) that, once triggered, the right cannot be lost by delay in exercising it, in principle we cannot see why a court should not give effect to those terms. That argument might involve persuading a court to confine the effect of the *Tele2* decision to its own facts – but these were extreme. As appears from [57] of Aikens LJ's judgment in that case, the innocent party allowed almost a year to elapse without any protest concerning the breach in question, or any reservation of rights, circumstances hard to envisage in the context of a commercial loan.

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Estoppel

As Lord Denning MR recognised in *WJ Alan & Co Ltd v El Nasr Export & Import Co* [1972] 2 QB 189 (CA) 212, while estoppel *"is much wider than waiver itself … waiver is a good instance of its application"*. Two particular types of estoppel are likely to be relevant in banking and finance disputes.

The first is promissory estoppel (sometimes called *"equitable forbearance"*). In broad terms, this prevents the innocent party from seeking remedies for breach of contract where the innocent party has represented to the party in breach that it would not seek to enforce its strict contractual rights, and the party in breach relied on that representation to its detriment. The court will ask whether it would be inequitable or unconscionable for the party to insist upon the remedy: *MWB Business Exchange Centres Ltd v Rock Advertising* [2016] EWCA Civ 533, [2017] QB 604 [52] – [61] (Kitchin LJ).

The second is estoppel by convention, which arises where the parties proceed to act on a transaction pursuant to an expressly shared, assumed state-of-affairs (the *"convention"* of the doctrine). The effect of such an estoppel is to preclude a party from denying the existence of the assumed state-of-affairs, if it would be unjust to allow him to go back on that assumption. To be bound, the party seeking to depart from such assumption must have been responsible in some way for its arising in the first place: see *HMRC v Benchdollar Ltd* [2009] EWHC 1310 (Ch) [52] (Briggs J).

Both these forms of estoppel act as "shields" not "swords": they do not create new enforceable consensual obligations but rather prevent a party seeking to enforce otherwise pre-existing consensual obligations. Application of no oral modification clauses is therefore not straightforward.

In *MWB v Rock* itself, Lord Sumption suggested that in, some situations, estoppel would be available as a *"safeguard against injustice"* from the application of a no oral modification clause (at [16]); but also pointed out that:

> "The scope of estoppel cannot be so broad as to destroy the whole advantage of certainty for which the parties stipulated when they agreed upon terms including the No Oral Modification clause. At the very least, (i) there would have to be some words or conduct unequivocally representing that the variation was valid notwithstanding its informality; and (ii) something more would be required for this purpose than the informal promise itself."

However, this dictum addresses the narrow question of an estoppel preventing a party from relying on a no-oral modification clause. It does not answer the broader question of whether a no-oral estoppel clause could take effect according to its terms.

While there is no authority yet on point, on balance, we doubt that a court would readily allow contractual terms to restrict estoppel in this way. These forms of estoppel are designed in part to temper the rigour of the common law's enforcement of contractual terms. It would be counter-intuitive to allow them to be confined by the very contractual terms whose effect they are meant to mitigate. That said, it is not easy to establish the essential requirements of estoppel, particularly in a standard arms-length commercial lending relationship.

Conclusion

There are likely to be many arguments about whether lenders have waived remedies or lost rights by not immediately enforcing remedies available to them when defaults and breaches occur. Lenders will often have the benefit of clauses like the LMA standard wording on waivers, but there is significant scope for argument about whether that wording would be effective for all types of waiver. Prudent lenders will therefore expressly reserve their rights from the outset and carefully document their interactions and any standstill or forbearance agreements reached with defaulting (or potentially defaulting) borrowers. Doing so, they may be better placed, and so more ready, to follow the encouragement of the PRA to show restraint during the COVID-19 crisis.

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