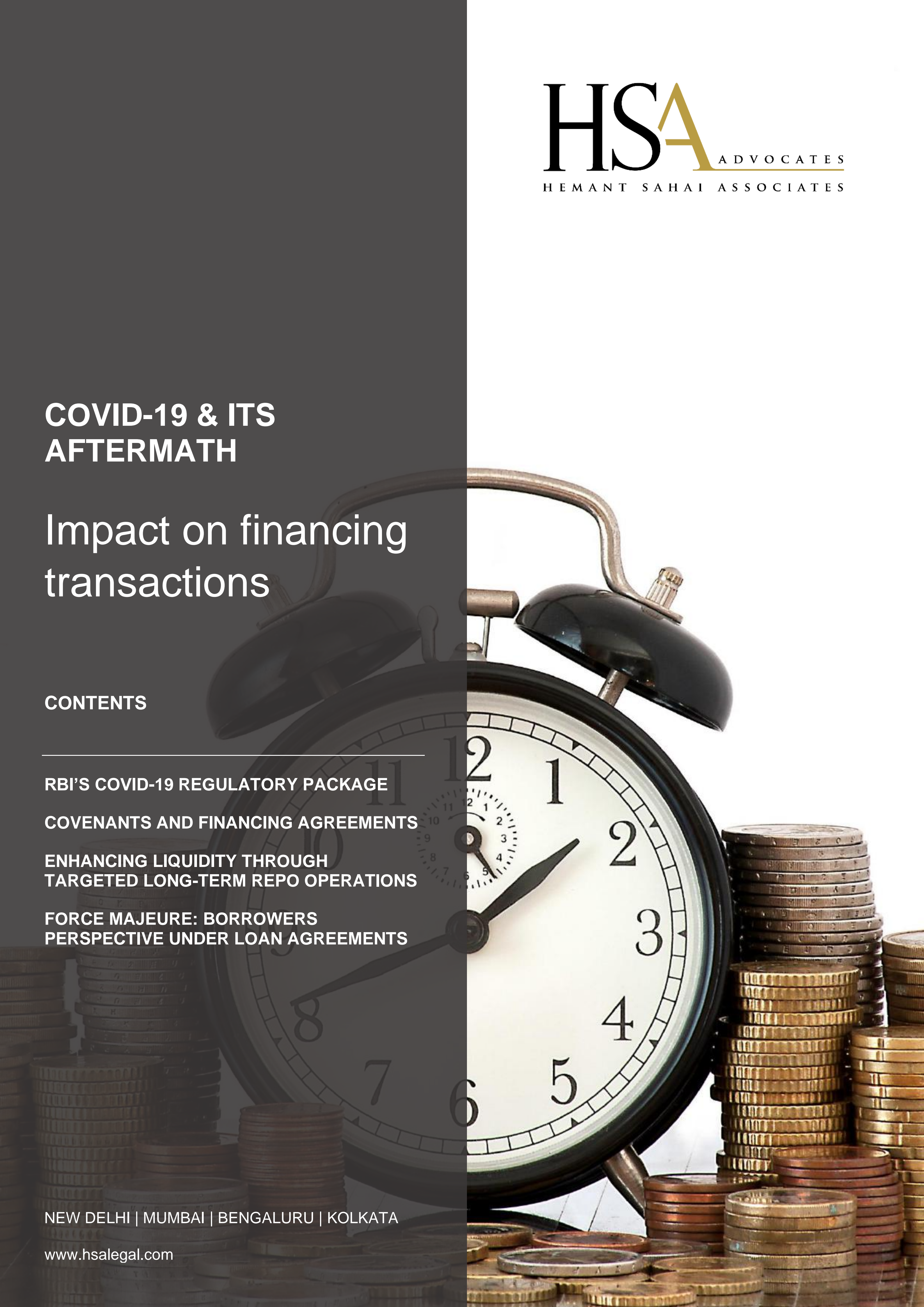

COVID-19 & ITS AFTERMATH

Impact on financing transactions

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RBI’s Covid-19 regulatory package

A timely response to the economic fallout

The ongoing Covid-19 pandemic and the nationwide lockdown has caused critical liquidity constraints and disruptions. To address these concerns, the Reserve Bank of India (**RBI**) announcement on March 27, 2020 of ‘Covid-19 – Regulatory Package’ (**Regulatory Package**) has provided much-needed succor to liquidity-starved borrowers. The Regulatory Package, which addresses the lending institutions[1], demonstrates the efforts undertaken to mitigate the burden of debt servicing and ensure continuity of viable businesses by granting the following significant reliefs:

The RBI Regulatory Package grants the following significant reliefs:

- Moratorium of three months on payment of all instalments[2] falling due between March 1, 2020 and May 31, 2020, in respect of all term loans[3] (**Moratorium**)
- Restraint on degradation of asset classification of the loan accounts availing the benefit of Moratorium (**Asset Classification**)

Mandatory or Recommendatory in nature?

There is much debate regarding the Regulatory Package being mandatory for lending institutions to abide by, or this being an advisory that recommends a certain course of action. The Regulatory Package does not contain sufficient clarity on this aspect and RBI too has not issued any clarification in this regard.

The Regulatory Package prescribes that Moratorium may be granted in respect of all the term loans and repayment schedule for such loans as also the residual tenor, will be shifted aacross the board by three months. However, FAQs issued by Indian Banks Association (**IBA**) in consultation with the Ministry of Finance provide that the benefit of the Moratorium is available to all loan accounts, which are ‘Standard Assets’ as on March 1, 2020.

Subsequently, a notification titled ‘Covid-19 Regulatory Package - Asset Classification and Provisioning’ was issued on April 17, 2020 which stipulated that in line with the clarification provided by the Basel Committee on Banking Supervision, in respect of all accounts classified as standard as on February 29, 2020, even if such accounts have overdues, the moratorium period, wherever granted, shall be excluded by the lending institutions from the number of days past-due for the purpose of asset classification under the IRAC norms.

In the midst of this ambiguity, a few recent judgements passed by the High Court of Bombay (**Bombay HC**) and High Court of Delhi (**Delhi HC**) touch upon the impact of Regulatory Package with regard to borrowing transactions. Tt appears that the courts are recognizing the current Covid-19 situation as a supervening event that impairs or affects the ability of borrowers under loan agreements. The underlying principle is that the borrowers have not committed a ‘willful’ default and the situation is beyond the ‘reasonable’ control of the borrower and these circumstances could not have been pre-empted or mitigated by the borrower. This is the classic legal definition of a force majeure.

A brief summary of these judgments is set out below:

- In a recent ad-interim judgement dated March 30, 2020, passed by the Bombay HC in the matter of *Rural Fairprice Wholesale Limited & Anr v. IDBI Trusteeship Services Limited & Ors*[4], the Court granted interim injunction restraining lenders action of enforcement of pledge of shares upon occurrence of a payment default by the borrower under the lending documents and observed that present Covid-19 situation/lockdown has badly affected the market leading to fall in stock prices of the pledged shares and therefore allowing enforcement of pledge of such shares at their plummeted prices (due to the prevailing Covid-19 outbreak) will cause loss to the borrower and may put the borrower in commercially perilous position. The aforesaid judgment by the Bombay HC was challenged by way of a special leave petition in the Supreme Court (**SC**). The apex court has observed in its order dated April 17, 2020 that the interim nature of the order is not likely to be interfered with under Article 136 of the Constitution and has accordingly dismissed the special leave petition.
- Thus, it appears that the courts are recognising the current Covid-19 situation as a supervening event that impairs or affects the ability of borrowers under loan agreements. The underlying principle is that the borrowers have not committed a ‘wilful’ default and the situation is beyond the ‘reasonable’ control of the

[1] All commercial banks (including regional rural banks, small finance banks and local area banks), all co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies)

[2] Instalments will include the following payments falling due from March 1, 2020 to May 31, 2020: (i) principal and/or interest components; (ii) bullet repayments; (iii) Equated Monthly instalments; (iv) credit card dues.

[3] Including agricultural term loans, retail, and crop loans

[4] Interim Application No.1 Of 2020 in Commercial Suit (L) 307 OF 2020

borrower and these circumstances could not have been pre-empted or mitigated by the borrower. This is the classic legal definition of a force majeure.

- The Delhi HC has in its order dated April 6, 2020 in the matter of *Anant Raj Ltd v. Yes Bank Ltd*[5] (**Anant Raj case**) ordered, inter alia, that the Moratorium relief is applicable even to loans which were on default as on March 1, 2020. Pertinently, the Delhi HC also observed that RBI's relief of Moratorium should be extended to a loan account categorized as a SMA-2 in the books of the lender (i.e. which was not a 'Standard Asset'), which is in contradiction with the FAQs issued by the IBA on 'RBI Allowed Banks to Declare Moratorium on Term Loans'. Further, the Delhi HC indicated that the extension of the said Moratorium should be extended to all borrowers across the board as mentioned in RBI Regulatory Package, and that the same is not recommendary.
- The Bombay HC vide its order dated April 11, 2020 in the matter *Transcon Skycity Pvt. Ltd & Ors v. ICICI Bank & Ors* and *Transcon Iconica Pvt. Ltd & Ors v. ICICI Bank & Ors*[6] has concurred with the view of the Delhi HC in Anant Raj case (discussed above) and held that the benefit of Moratorium as per the Regulatory Package shall be available to the borrowers, in the instant case who were in default as on March 1, 2020. The Bombay HC also observed that period of Moratorium during which there is a lockdown will not be reckoned by lender for computation of the 90-day period for Non-Performing Asset (**NPA**) declaration as per the extant RBI guidelines.
- In another very recent order dated April 13, 2020 passed by the Delhi HC in the matter of *Shakuntla Educational & Welfare Society v. Punjab & Sind Bank*[7] the Delhi HC concurred with the observations of co-ordinate bench in the matter of Anant Raj and observed that the intention of the RBI while issuing the regulatory package was to maintain status quo with regard to the classification of accounts of the borrowers as they existed on March 1, 2020. It is pertinent to note here that even though Shakuntla Educational & Welfare Society failed to pay the instalments which were due on or before December 31, 2019, the Delhi HC took due cognizance of the fact that the receivables of Shakuntla Educational & Welfare Society were affected due to State Government's directive prohibiting the collection of fees from the students. Accordingly, the Delhi HC directed that till the next date, the Punjab & Sind Bank stood restrained from declaring the Shakuntla Educational & Welfare Society accounts as NPA.

The conclusions drawn from all the above-mentioned judgements, essentially stipulate that Moratorium should be granted across the board to all borrowers, status quo should be maintained during the Moratorium and the asset classification of loan accounts should not be downgraded.

However, it is pertinent to mention about another recent judgements dated April 7, 2020, passed by the Bombay HC, in the matter of *Ideal Toll & Infrastructure Pvt Ltd and Anr. v. ICICI Home* Finance *Co Ltd and Anr*[8] and *Mrs. Anuya Jayant Mhaiskar v. ICICI Home Finance Co Ltd and Anr*[9] , which to a certain extent has a slightly contradicting ratio. In the aforesaid judgement, the Bombay HC directed the borrower to repay the overdues which fell due before March 1, 2020, the Moratorium start date, as per the rescheduled repayment dates proposed by the Bombay HC, falling between April 18, 2020 and May 15, 2020. The Bombay HC further observed that no further pledge shall be invoked and the loan account shall not be classified as an NPA by the lender, unless there occurs a default in respect of the amounts payable by the borrower pursuant to the rescheduled repayment dates stipulated by the Bombay HC.

Conclusion

The notification titled 'Covid-19 Regulatory Package – Asset Classification and Provisioning' issued on April 17, 2020 indicates that only accounts classified as standard as on February 29, 2020, even if there may be overdues, are eligible for the moratorium reliefs. However, the spirit of Regulatory Package is to prevent further deterioration of financial position and alleviate liquidity constraints faced by borrowers on account of present Covid-19 pandemic and its resultant fallout. Thus, it may be argued that in order to maintain the sanctity of the Regulatory Package and to achieve the objective mentioned therein, the lenders should allow/grant requisite moratorium, irrespective whether the loan account is standard or not, which also appears to be the larger perspective being followed by the Courts, subject to the extant RBI guidelines.

[5] W.P.(C) Urgent 5/2020
[6] Writ Petition LD-VC NO. 28 of 2020 and Writ Petition LD-VC no. 30 OF 2020
[7] W.P.(C)2959/2020
[8] Commercial Suit No. LD-VC-7 of 2020 along with Interim Application No. LD-VC-7 (IA) of 2020
[9] Commercial Suit No. LD-VC-8 of 2020 along with Interim Application No. LD-VC-8 (IA) of 2020

Covenants and financing agreements

Covid-19 pandemic and the subsequent lockdown has impacted ongoing financing transactions as well as existing financing arrangements. Primarily, the impact is on the following areas:

- Ability on generation of cash flows which may impact the payment cycle and thus risk of potential default
- Ability to comply with the covenants in the financing documents
- Liquidity in the market

In order to effectively assess and allocate risk, it is essential that the financing documents be subjected to a comprehensive review to assess immediate or subsequent challenges and optimal mitigation strategies adopted for curbing any negative impact.

Towards this end, the first task should be to ascertain whether there is a force majeure clause covering Covid-19 pandemic as a force majeure event in the financing documents. If yes, then a communication in this regard with the lending institution is required to be established – relief on account of force majeure will depend on a case-to-case basis, and generally one of the reliefs provided in the financing documents is suspension to perform the obligations during the force majeure period, which may give some preparation time for dealing with the situation.

However, if the force majeure clause is not provided in the financing documents, then it is imperative to list out the critical covenants which may have impact on the financing arrangement. Broadly, covenants in the financing documents are:

- **Financial covenants** – Where generally no cure period is provided, breach of such covenants may lead to financial loss, such as, penal interest, default interest, infusion of additional funds, additional cost, etc. Some of these covenants include:
  - Making the payment of coupon and the principal, redemption of corporate bonds, commercial papers, debentures, etc., as per the payment schedule
  - Maintaining the debt service reserve account (**DSRA**)
  - Any other reserve account as may be required to be maintained as per the financing documents – this may generally include stamp duty, fees, charges, etc.
- **Non-financial covenants –** Where generally cure period is provided and the same are reviewed on a periodic basis by the lending institutions. While there may not be immediate impact, these need to be reviewed and any gap needs to be bridged to ensure continuity in the financing arrangement and avoid financial implications. Breach of non-financial covenants may lead to the lending institution asking for any of the following:
  - Providing additional security or alternate security
  - Reassessment of the sanction/facility or revision in the business plan, in which case, the lender may
    - Reduce the sanction limit (if all the limit is not exhausted) or drawing power
    - Ask for prepayment to reduce the overall credit exposure on the borrower.

  Whilst there may be laundry list of such covenants, some of these *(*depending on the nature of borrowing like term loan, working capital facility, LRD, structured finance, project finance, etc.) would include:
  - Security Cover Ratio
  - Loan-to-Value Ratio
  - Debt to Equity Ratio (if there is future covenant to infuse equity in the SPV)
  - Material Adverse Effect (**MAE**) which will generally cover the instances which may impact the ability to carry on business as per the business plan, servicing the debt as per the payment schedule, affecting the security, etc.
  - Deviation in Business Plan
  - Cessation or suspension of business

While potential relief measures may be built into financing agreements (such as force majeure provisions), borrowers should plan ahead for adverse outcomes that could possibly ensue by seeking moratorium, seeking waiver or extension of cure period, deviation in business plan, change in key ratios, etc.

Enhancing liquidity through targeted long-term repo operations

Covid-19 ignited large sell-offs in the domestic equity, bond and forex markets leading to an increase in redemption pressures. This led to a surge in liquidity premia on instruments such as corporate bonds, commercial paper and debentures and it became difficult for these instruments to access working capital through bank credit.

To counter the economic impact and subsequent pressure on cash flows, RBI decided to conduct auctions of targeted term repos of up to three years tenor of appropriate sizes for a total amount of up to INR 100,000 crore at a floating rate linked to the policy repo rate. As of April 17, 2020, the RBI conducted the fourth TLTRO for a notified amount of INR 25,000 crores each with a 3-year tenor. As part of second Covid-19 rescue package, and specifically, to ease liquidity for NBFCs, RBI on April 17, 2020 also announced TLTRO 2.0 worth an initial amount of INR 50,000 crore.

LTRO is a tool that lets banks borrow one to three-year funds from the central bank at the repo rate, by providing government securities with similar or higher tenure as collateral. It is called 'Targeted' LTRO as in this case, central bank wants banks opting for funds under this option to be specifically invested in investment-grade corporate debt.

This helps banks get funds for a longer duration as compared to the short-term liquidity provided by the RBI through relaxations in Liquidity Adjustment Facility (**LAF**) and Marginal Standing Facility (**MSF**).

LTROs provide banks with access to cheaper capital from the RBI. This, in turn, encourages them to lend more and spur economic activity. They can also invest these long-term funds in assets that yield better returns to improve profitability. As banks provide government securities as collateral, the demand for such government bonds increases and helps in lowering yield.

RBI's LTRO guidelines for banks

Will banks be required to maintain specified securities for amount received in TLTRO in HTM book at all times?

Yes. Banks will have to maintain amount of specified securities for amount received in TLTRO in its HTM book at all times until the maturity of TLTRO.

Will bank have to necessarily continue to hold an amount equivalent to what it was holding as on March 26, 2020, in its HFT/AFS portfolio for tenor of TLTRO borrowing?

Under TLTRO scheme, banks will have to invest amount borrowed under TLTROs in a fresh acquisition of securities (i.e. over and above their outstanding statement in specified securities it was holding as on March 26, 2020) from primary/secondary market. However, participation in TLTRO scheme will not impinge on the existing investment of bank and bank may continue to operate their AFS/HFT portfolio, as hitherto, in terms of extant regulatory/internal guidelines.

Is there any maturity restriction on the securities to be acquired under the TLTRO scheme?

There is no maturity restriction on specified securities to be acquired under TLTRO scheme. However, outstanding amount of specified securities in bank's HTM portfolio should not fall below level of amount availed under TLTRO scheme. The specified securities acquired under the TLTRO scheme will be allowed to remain in HTM portfolio till their maturity.

Can a bank categorize specified securities acquired under the TLTRO scheme as AFS or HFT?

Specified securities acquired under TLTRO scheme will be classified in HTM category. However, if a bank decides to classify such securities under AFS/HFT category at time of acquisition, it will not be allowed to later shift such securities to HTM category and it should maintain sufficient records to demonstrate and separately identify securities purchased under TLTRO scheme within the AFS/HFT portfolio. Further, all regulations applicable to securities classified under AFS/HFT including those on valuation will be applicable on such specified securities.

What happens if a bank fails to deploy the funds availed under the TLTRO scheme in specified securities within the stipulated timeframe?

Banks have already been given sufficient time to deploy funds availed under TLTRO scheme. It has now been decided to allow up to 30 working days for deployment in specified securities for those banks who have availed funds under the first tranche of TLTRO. However, if a bank fails to deploy funds within specified time frame, interest rate on un-deployed funds will increase to prevailing policy repo rate plus 200 bps for number of days such funds remain un-deployed. This incremental interest will have to be paid along with regular interest at the time of maturity.

Under TLTRO scheme, specified eligible instruments will have to be acquired up to 50% from primary market issuances and remaining 50% from secondary market. Is this limit fungible between primary and secondary market?

The deployment of funds availed under TLTRO in primary market cannot exceed 50% of the amount availed. Apart from the above stipulation, the limits are fungible between primary and secondary market deployment.

Force majeure: Borrowers perspective under Loan Agreements

Impacting of outbreak on borrowers' obligations under the loan documents

The Government of India, through its various departments and ministries have taken due cognizance of the ongoing situation and measured the present crisis as 'force majeure' event, impacting performance of contracts. The Ministry of Finance on February 19, 2020 declared 'corona virus' as a natural calamity akin to 'force majeure' and the Ministry of New & Renewable Energy on March 20, 2020 directed all renewable energy implementing agencies to treat delay on account of disruption to the supply chain due to Covid-19 as a 'force majeure' event.

The Borrowers' community is also facing the brunt of the present Covid-19 crisis and the fallouts of resultant countrywide lockdown has impacted the performance of their contractual obligations under the loan documents towards their lender(s) including their ability to service the debt. Certain loan agreements provide that subsistence of stipulated 'force majeure' event beyond a particular time period would result in an event of default (**EoD**). Further, even if occurrence/subsistence of 'force majeure' events is not *per-se* an EoD, occurrence of situations like that of present Covid-19 crisis and the likes may be argued by the lenders to have triggered other EoD clauses such as material adverse effect, availing of moratorium by the borrower, suspension of business operations/cashflows, inability to pay debt, stoppage of work/operations under the project documents etc. Thus, this situation due to Covid-19 is likely to trigger various EoD clauses under the loan documents and may lead to actions viz. acceleration of loan, enforcement of security and invoking other consequences to EoD stipulated under the loan documents including invocation of IBC provisions against the borrower, by the lenders.

In this backdrop it is significant to examine whether the present Covid-19 pandemic and its resultant fallouts can be considered to be events qualifying as 'force majeure' or having the effect of 'force majeure' such that the Borrower would be entitled to claim the benefit of reprieving from performance of their obligations towards their lenders under the loan documents including in respect of their debt service obligations under the provisions of the loan documents and/or Indian Contract Act, 1872 (**ICA**). Thus, this analysis can be broadly divided into situations where:

- The loan documents which provide for a 'force majeure' clause
- The loan documents which do not contain a 'force majeure' clause

Loan documents providing force majeure clause

Whilst mostly the loan documents do not contemplate a 'force majeure' event but certain loan documents in respect of project finance transactions - define the term 'force majeure' having the meaning ascribed to it under the project documents. Usually the definition of 'force majeure' in project documents cover events like act of God; any act of war including invasion, armed conflict or act of foreign enemy, blockade, embargo, revolution, riot, insurrection, terrorist or military action; and radioactive contamination or ionizing radiation and may or may not cover pandemic/epidemic or lockdown of the kind presently prevalent in the country.

However, if the loan documents contain a definition of 'force majeure' (or imports meaning of 'force majeure' by reference to some other document), then very briefly – the following need to be examined:

- If the 'force majeure' event described under the loan documents covers directly the present kind of situation i.e. pandemic/epidemic or lockdown or not; and if not – then would such pandemic /resultant lockdown situation be covered under other 'force majeure' events described under the loan documents viz. act of God, national disaster, natural calamity etc.
- If the present Covid-19 crisis would get covered under the 'force majeure' event provided under the loan documents then what are the specific reprieves granted to the Borrower from performance of its obligations under relevant 'force majeure' events, and also if such 'force majeure' events can be extended and applied to claim relief for other obligations not directly linked to the 'force majeure' events, including the debt service obligation of the Borrower.

In several landmark cases including in *Satyabrata Ghose v. Mugneeram Bangur & Co*[10] and *Energy Watchdog v. CERC*[11], the Supreme Court has applied the following tests to determine validity of Force Majeure events:

- Whether the event qualifies as force majeure under the contract?
- Whether the risk of non-performance was foreseeable and able to be mitigated?
- Whether performance is truly impossible?

The relief available upon invoking 'force majeure' clause will depend upon the provisions laid down in the loan documents. It is a settled legal proposition that unless a particular event may clearly fall within the ambit and scope of 'force majeure' clause under the contract, the judicial forums may not accept the same as a triggering event to provide the desired contractual relief of non-performance (as seen in *Energy Watchdog Case*). Now, whether Covid-19 could be used to trigger the 'force majeure' clause would depend on the language embodied in the loan documents. A Borrower may be able to claim specific reliefs under this clause if:

- Force majeure clause provides for epidemics, pandemics, quarantines, lockdowns, or government intervention/declaration as a result of the aforesaid.
- In addition, presence of generic words like "extraordinary circumstances beyond control of contracting parties" or similar words may also be tested to trigger the clause for outbreak of Covid-19.

Even if Covid-19 qualifies as a 'force majeure' event, it becomes important for a Borrower to establish and factually prove that it has caused the Borrower to be unable to perform its obligations under the loan documents, and such impossibility / inability can be directly attributed to Covid-19 and its resultant fallouts. Further, it is pertinent to highlight that on similar lines, even the lenders may also apply the aforementioned tests to determine the validity of the 'force majeure' event claimed by a Borrower.

In case the force majeure clause does not contemplate any events like epidemic/pandemic or lockdown, then the Borrower(s) may explore whether 'government action/declaration' that has resulted in its inability to perform its obligations under the loan documents, can be used to expand the ambit of the existing 'force majeure' provisions. However, the Borrower should first ascertain whether non-performance is due to the outbreak of Covid-19 itself or the resulting government action for controlling infections such as limitations on transportation, self-quarantines, closures of premises, etc.

It is important to note that whether a party can be excused from performance of its obligations claiming Covid-19 as a pandemic will also depend on the nature of the contract, a party's obligation therein and its duty to mitigate. 'Duty to mitigate' will usually entail all reasonable endeavors undertaken by the Borrower to perform its obligations, and the Borrower would be expected to establish its bonafide intention in this regard.

Having said the above, mostly, the loan documents stipulate limited relief measures upon occurrence of a 'force majeure' event which may not be adequate enough to help a Borrower mitigate the present situation and consequently the challenges remain unresolved. In such circumstances, it is imperative for a Borrower to establish that due to the present situation being a force majeure event or akin to force majeure, the Borrower is unable to fulfil all the other contractual obligations.

Loan documents not providing force majeure clause

In absence of a specific 'force majeure' clause, essentially the understanding/ interpretation needs to be derived from the applicable laws. Force Majeure is essentially a common law principal and there is no statutory definition of Force Majeure under the Indian laws. This said, the principle is embodied in Section 32 and 56 of ICA which provide that in case any act to be performed pursuant to a contract becomes impossible to perform, then such an act will become void.

In absence of a specific 'force majeure' clause, the Borrower may seek the benefit embedded under Section 56 of the Indian Contract Act, 1872 by factually demonstrating before a court that the purpose and underlying principles of the contract have been eroded/ frustrated and the performance under the loan documents has become impossible. The essential element for a claim of force majeure is impossibility of performance of the contract and the party claiming force majeure carries the burden of proof. In this context, it is important to remember that it is a settled law that abnormal rise in price, onerous conditions or change in circumstances do not lead to frustration of contract (*Alopi Parshad and Sons Ltd. v. Union of India*[12]) – it will have to be proved on facts that the frustrating event has led to the fundamental basis of the contract being dislodged.

Thus, for claiming relief enshrined under Section 56 of ICA in respect of non-performance of contractual obligations of the Borrower under the loan documents, including debt servicing, due to the outbreak of Covid-19 and its resultant fallouts, the Borrower would have to factually prove that the present pandemic and consequent disruption/lockdown etc. has made it impossible to perform the obligations under the loan documents. Having said that, the outcome would depend on the facts of each case.

[10] AIR 1954 SC 44
[11] (2017) 14 SCC 80
[12] AIR 1960 SC 588

HSA at a glance

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