COVID-19: Loan Agreement Considerations for Corporate Borrowers

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A Practice Note discussing issues related to the COVID-19 pandemic that corporate borrowers may need to address under their loan agreements.

With the ongoing uncertainty surrounding the economic effects of and government and corporate responses to the 2019 novel coronavirus disease (COVID-19) pandemic, borrowers and other loan market participants must consider multiple issues under their loan agreements. The most pressing issue for many borrowers in the short term is the preservation of liquidity, and the ability to access additional liquidity, in the face of falling revenues. Over the coming weeks and months, many borrowers will face additional covenant compliance issues. This Practice Note discusses these issues and offers guidance to borrowers affected by COVID-19.

PRESERVING LIQUIDITY

Preserving the borrower's cash position most obviously involves drawing down available lines of credit, but borrowers may also preserve cash by other means, such as raising incremental financing, minimizing prepayments, selling assets, and reducing or delaying expenditures.

DRAWING DOWN UNDER EXISTING REVOLVERS

Borrowers may want to draw down their existing revolvers for a variety of reasons. If their revenues are declining as a result of the pandemic, they may want to borrow money to bolster their cash reserves to enable them to meet their payment obligations until conditions return to normal. Weaker borrowers may anticipate needing to restructure as a result of the crisis and may wish to borrow now under their existing facilities to avoid or reduce the immediate need for expensive debtor-in-possession or rescue financing in any later restructuring. Others may wish to borrow now fearing that they may be unable to meet their borrowing conditions at a later date or that banks may in time be unable to lend if the economic effects of the crisis deepen and are prolonged.

In the present context, drawing down under an existing revolver presents several issues, including whether the borrower can meet the loan agreement's conditions to borrowing, in particular the material adverse effect representation (the MAE Rep). Loan agreements require the borrower to represent at each revolving borrowing, as a condition precedent to that borrowing, that nothing has occurred that has, or could reasonably be expected to have, a material adverse effect. However, there is some variation in the way loan agreements define material adverse effect. Some considerations include:

- Whether the representation has a prospective element, such as a reference to the borrower's "prospects" in the material adverse effect definition or a reference to whether the applicable event "could reasonably be expected to have" a material adverse effect. If those elements are not present a material adverse effect may be more difficult to prove.
- What the material adverse effect applies to. For example, some loan agreements limit the MAE Rep to a material adverse effect on the borrower's payment obligations, which is a narrower, more borrower friendly formulation than a material adverse effect on the borrower and its business.
- Whether there are exceptions. Some loan agreements carve out public disclosures made prior to the effective date of the loan agreement, and those carve-outs can be significant, particularly if they are written in a way that would allow the borrower to exclude broadly drafted risk factors in securities offering documents or periodic reports required by the Securities Exchange Act of 1934.

Borrowers should consider the wording of the MAE Rep in their loan agreements carefully. In addition, it is generally accepted that for a material adverse effect to occur:

- The adverse impact must be sufficiently material, typically measured by a large reduction in EBITDA, revenue, or a similar metric.
- The adverse impact must be durationally significant, sometimes said to be measured in years not months.
- The adverse impact should be unanticipated.
- The events giving rise to the material adverse effect must be outside the control of the parties.

The borrower and its advisors will need to take these factors into account, together with the language of the loan agreement, to evaluate whether in the light of the COVID-19 pandemic the borrower can make the MAE Rep at the time it wishes to borrow.

A misrepresentation under a loan agreement results in an event of default, which allows the lender to take action against the borrower. The actions may be as severe as terminating their lending commitments and accelerating and demanding repayment of the outstanding loans.

Lenders improperly declining borrowing requests are at risk of lender liability. Although the terms of most loan documents will limit the extent of that liability, a determination by a lender that there has been a material adverse effect will not be taken lightly. The uncertainty regarding the depth and duration of the effect of the COVID-19 pandemic would make it difficult presently for most lenders to conclude with confidence that a material adverse effect has occurred. This is highly dependent on the particular facts and may change as time passes and the full effect of the COVID-19 pandemic manifests.

It is important to bear in mind that the MAE Rep is not the only condition that needs to be satisfied as a condition to borrowing. Many loan agreements require the borrower to:

- Make a solvency representation.
- Represent that there is no material litigation.
- Show it is in compliance with its material contracts.

All of these could be affected by the pandemic. A borrower will need to carefully assess each representation and confirm there is no default (such as for the late delivery of financial information) in determining whether they can draw down on their revolving credit facility.

Drawing down on the revolving facility also requires the borrower to bear the additional interest on the borrowed funds. The borrower should ensure it can pay the additional interest.

By drawing the revolving facility, borrowers that have "springing" financial covenants in their loan agreements may need to start complying with their financial covenant test (although in many cases they can net the drawn cash in running the ratio calculations). Relatedly, borrowers under asset-based loans may, by making additional borrowings under their loan agreements, trigger provisions that only apply after a certain percentage of the commitment has been used. Different percentages may apply to different provisions, but exceeding usage-based triggers in an asset-based revolving facility may cause:

- The interest rate margin to increase.
- Unused line fees to increase.
- Covenant permissions and exceptions to become more stringent.
- Springing financial covenants to take effect.
- Cash control measures to become more stringent.
- Additional borrowing base reporting and collateral appraisals to be required. For more information on usage-related provisions in asset-based loans, see Practice Note, Borrowing Base: Impact of Excess Availability (6-501-5692).

Many borrowers negotiate detailed covenant exceptions, which allow them to take certain corporate actions, such as paying dividends and making investments, subject to compliance with a leverage ratio. A higher leverage ratio (which may result from borrowing under the revolver) means that the borrower has less ability to rely on these covenant exceptions. However, to the extent the drawn cash is held on the balance sheet and is able to be netted from debt in running the ratio tests, this issue may be less significant. For more information on conditions to borrowing in loan agreements, see Practice Note, Loan Agreement: Conditions Precedent in a Loan Transaction (5-381-7459), and for sample provisions of borrowing conditions, see Standard Clauses, Loan Agreement: Conditions Precedent (2-383-2927).

PRESERVING CASH BY OTHER MEANS

Borrowers may also seek to improve their cash positions by taking other corporate action:One option may be to sell assets or delay investment decisions. However, many loan agreements contain provisions that may be implicated by these courses of action:

- These actions may solve short term liquidity needs but may exacerbate the effect on the borrower's business and its ability to recover when normal conditions return, which may in turn affect its ability to meet financial metrics in the long term.
- Borrowers should review and consider whether they can satisfy any conditions in their loan agreements that must be met before the borrower can effect a sale of assets, which will include obtaining necessary collateral releases (which may require consent if they are sufficiently large) or satisfying minimum cash, fair market value, and no default conditions.
- Borrowers should also consider any mandatory prepayment provisions that may be relevant to an asset sale. Many loan agreements require all or a portion of asset sales proceeds to be used to pay down existing loans, which would undermine the purpose of selling those assets to bolster cash reserves.

Borrowers may look to proactively manage operations to ensure that no mandatory prepayment is required under their loan agreement because an excess cash flow sweep is triggered. Many loan agreements now afford borrowers considerable flexibility to reduce excess cash flow sweeps, often on a dollar-for-dollar basis. For more information on mandatory prepayments in loan agreements, see Practice Note, Loan Agreement: Prepayment and Commitment Reduction Provisions (8-501-6488), and for sample provisions regarding mandatory prepayments see, Standard Clauses, Loan Agreement: Prepayment and Commitment Reduction Provisions (2-384-1535).

If the liquidity need is sufficiently great and the borrower has access to financing sources, the borrower may seek side-by-side or incremental financing. Many recent loan agreements afford borrowers considerable flexibility to raise incremental short-term senior debt or to segregate assets to secure financing provided by liquidity providers through, for example, an unrestricted subsidiary. A close analysis of the loan agreement is required.

Finally, depressed debt trading prices may present a deleveraging opportunity for borrowers who can cancel debt at less than par and reduce interest burden. For more information on loan buybacks and examples of loan buyback provisions from publicly filed loan agreements, see Practice Note, What's Market: Loan Buybacks (1-385-9682).

COVENANT COMPLIANCE

As the COVID-19 pandemic evolves and protective measures continue to affect businesses and the wider economy, borrowers and lenders should pay close attention to their loan agreement covenants and plan to address issues as they arise. For loan agreement covenant purposes, the effects on many borrowers may not begin to be felt until around early May when they report their EBITDA for the first quarter of 2020. Unless issues are proactively addressed, loan agreement defaults may start to become more widespread from this time. Reporting delays also mean that the effects of the crisis will continue until after the economic recovery has begun. Planning and dialogue between borrowers and lenders are important to ensure that there are fewer surprises, and that appropriate courses of action to address problems are properly considered.

Borrowers should review their loan agreements and consider the following:

- The need to update their business plans and projections (which may be challenging given continuing uncertainty).
- Complying with their reporting obligations. Loan agreements require borrowers to provide their lenders with information, notices, reports, and compliance certificates (see, Loan Agreement Checklist: Borrower's Compliance Best Practices, Reporting Obligations (W-001-8723)). The provisions are negotiated and vary among loan agreements, but the borrower's failure to comply is ultimately an event of default. Borrowers should review their loan agreement reporting obligations and consider the effects of the COVID-19 pandemic on their requirements, especially:
  - notification of material events affecting the borrower as a result of the pandemic, such as sales disruptions and difficulties under commercial contracts due to supply chain disruptions;
  - compliance certificates that may be required periodically or at specified times, such as a borrowing or some other corporate action. These certificates typically require the borrower to certify that there are no defaults and that representations are true and correct, though the exact wording of each individual loan agreement is key as there is some variation. The discussion above regarding the MAE Rep is relevant if the compliance certificate requires a bringdown of the MAE Rep;
  - notification of a default. Loan agreement covenants are bespoke in each transaction and there are many variations. Borrowers should consider whether the effect of the COVID-19 pandemic results in a breach of a loan agreement covenant. For example, falling revenues as a result of the pandemic may cause the borrower to fail a leverage ratio requirement; and
  - the ability to deliver timely audits when audit firms have expressed uncertainty about their ability to complete site visits in this time of social distancing.
- Complying with any maintenance financial covenants. Many loan agreements contain maintenance covenants that require the borrower to maintain a specified financial metric on an ongoing basis, such as a leverage ratio or an interest coverage ratio. These ratios are usually measured against EBITDA. If the borrower's EBITDA declines as a result of the pandemic, it may fail to maintain a required ratio, resulting in an event of default. Similarly, many of these loan agreements calculate leverage on a "net debt basis," so to the extent liquidity is constrained and there is less cash on the balance sheet, leverage will increase.
- Complying with any incurrence tests. Many loan agreements (known as covenant-lite loan agreements) contain incurrence financial covenants which require the borrower to meet a specified financial metric whenever some particular corporate action occurs (for example, the borrower incurs debt or makes an investment). The borrower must only satisfy the required financial test if it wishes to take some action; it does not need to comply with the financial covenant at all times. The impact of the COVIOD-19 pandemic on the borrower's business could leave it unable to take certain actions because falling revenues mean it is unable to meet an incurrence test. For more information on financial covenants in loan agreements, see Practice Note, Loan Agreement: Financial Covenants (3-384-0955).
- EBITDA addbacks that may be used to lessen the impact of the pandemic on the borrower's financial results. One-time, extraordinary expenses related to COVID-19 may be within the scope of the loan agreement's add-backs. EBITDA add-backs typically can only be used to add expenses back to revenues, not to supplement a shortfall of revenue (although as always the words used in the loan agreement are important). For more information on EBITDA add-backs, see Practice Note, Boosting EBITDA: The Cost Savings Adds-Back (1-511-7909).
- Cross-defaults to other debt agreements. Loan agreements commonly contain cross-default provisions, which result in an event of default if the borrower defaults under another debt agreement, typically above a specified threshold amount. The opposite may also be true, so a borrower should be aware of defaults under other agreements that would occur if there is an event of default under its loan agreement.
- The effect on third-party trading agreements. Some loan agreements also contain material contracts provisions, which can result in an event of default if the borrower defaults under trading agreements with important customers or suppliers on which its business depends. Disrupted trading conditions as a result of the COVID-19 pandemic could give rise to defaults under these types of covenants.
- The diminution of any borrowing base caused by difficulties with trading partners and sale and supply arrangements resulting from the pandemic. For example, if a borrower's customers experience financial difficulties, the underlying receivables may become ineligible for inclusion in the borrowing base. Equally, if a borrower is unable to obtain inventory or materials because of disruptions to supply chains, the borrowing base will be reduced resulting in lower borrowing capacity. For more information on borrowing bases in loan agreements, see Practice Note, Borrowing Base: Overview (2-501-4029).
- Whether the loan agreement contains a material adverse effect event of default. Some loan agreements include an event of default for an occurrence that results in a material adverse effect on the borrower's business. In practice, lenders are reluctant to

take action based on a material adverse effect event of default in the absence of any payment or other covenant breaches by the borrower.

- Whether the loan agreement's bankruptcy events of default contain early triggers. Events of default for bankruptcy events affecting the borrower are standard in loan agreements. However, the drafting of individual provisions is key and in some loan agreements early action taken by the borrower in times of increasing financial distress (but before any bankruptcy filing) may constitute an event of default. Borrowers should understand whether events, such as a balance sheet insolvency, admitting their inability to pay debts in any disclosures, or even having discussions with trading partners about resolving problems in commercial contracts, could result in an event of default.

RESOLVING PROBLEMS

Borrowers facing covenant breaches under their loan agreements should consider:

- Whether short-term relief, such as delaying interest, other scheduled payments and mandatory prepayment sweeps, or one-time waivers of covenant defaults, are sufficient to address the problems.
- Seeking an amendment to their loan agreement if:
  - the pandemic results in lasting changes to the borrower's business; and
  - certain loan agreement covenants are no longer viable.
- Whether additional financing (including financing that may be made available under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) or other government programs) is available that might address the borrower's financial problems.
- What they can offer their lender as an incentive to agree to a restructuring of their loan agreement, such as:
  - additional collateral if the borrower has unencumbered assets;
  - additional guarantees;
  - an increased interest rate margin; or
  - additional or modified covenants, such as tighter covenant restrictions and additional reporting requirements.
- The availability of replacement financing if the borrower is unable to agree to a necessary modification of its loan.
- Whether equity cures can be used to remedy covenant breaches, such as by boosting EBITDA, and whether equity is available. For more information on equity cures and examples of equity cure provisions from publicly filed loan agreements, see Practice Note, What's Market: Equity Cure Rights (9-508-0737).

It is too soon to estimate how far reaching the effects of the COVID-19 pandemic will be or for how long governments will impose stringent measures to combat the spread of the virus. Its economic effect is already huge. Given the level of uncertainty surrounding the pandemic, the best course for borrowers and lenders is to be proactive and to keep open lines of communication so that they may anticipate problems under their loan agreements and take early action to solve them.

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