In the Context of Corporate Lending, Should Parties Push the Pause Button?

The COVID-19 pandemic has wreaked havoc on financial markets and businesses around the world. In a time of social distancing, constrained supply chains, depressed demand in almost all sectors of the economy, and tightening of the credit markets, many borrowers stand to suffer devastating effects. For this reason, participants in credit markets must review existing credit facilities and assess how best to move forward. Regardless of a particular borrower’s situation, it is imperative that all borrowers maintain open channels of communication with their lenders during this period of uncertainty and anticipate problems before they occur whenever possible, so as to give lenders the information needed to evaluate potential relief from various loan terms and other concessions that might enable the borrower to continue operating and avoid default. Likewise, lenders should consider whether there are certain provisions in their credit agreements they are willing to waive or defer temporarily in order to accommodate struggling borrowers, but they
should not be expected to anticipate the needs of their borrowers, making direct communication by the borrowers all the more crucial. While borrowers and lenders do not have perfectly aligned interests, both sides would be well advised to remain flexible, communicate early and often and “push the pause button” in order to avoid mass defaults throughout the market.

While we are still in the early stages of this pandemic, many lenders believe this period of economic stress will not subside quickly, and may even last throughout 2020. Therefore, lenders would be well served to review existing credit agreements and financial reporting and consider ways in which they can work with borrowers to avoid default. One way to spot early warning signs is to review borrowers’ financial reports and run financial covenant analyses. Possible workarounds for looming breaches of financial covenants include adjusting financial covenant ratios and allowing borrowers more time and ability to cure with respect to leverage and cash flow covenants. Financial covenants and related reporting will be increasingly important going forward, as most reporting is done quarterly, and the second quarter of 2020 is likely to be significantly more adversely affected by the COVID-19 crisis than the first quarter, and the impact in the later quarters is at this point unforeseeable. Although somewhat premature today, in the coming months lenders might also consider extending maturity on existing loans and holding off on calling defaults. For certain borrowers, it is also possible that lenders could allow a temporary suspension of principal and interest payments (however, interest would continue to accrue during such deferral period).

Furthermore, both sides must carefully review the representations and warranties being given by borrowers, particularly in a draw-down or other credit event scenario, with a keen eye toward the no default, no litigation, compliance with material obligations, solvency, and no material adverse effect (MAE) representations. If these representations are not accurate when made, it could lead to an event of default and possible litigation, increasing friction, further exacerbating the issues and reducing the goodwill and hard-earned efficiencies between the parties.

Ultimately, the actions taken by lenders will vary from borrower to borrower based in large part on the borrower’s industry, financial health, pre-pandemic credit quality and the existing relationship between the parties. Borrowers in hard-hit sectors like energy, travel and hospitality that are likely facing long-term and continuously disrupted revenue streams may wish to draw on existing credit facilities and even seek commitment increases to address liquidity needs. They will undoubtedly seek to work with lenders to find solutions such as temporarily deferring payments of interest and/or principal, temporarily waiving restrictions on equity cures or even excluding fiscal periods impacted by COVID-19 for purposes of calculating EBITDA and other covenant components. In exchange for these concessions, some borrowers should be prepared for lenders to impose additional requirements, such as implementing strict cash management arrangements (e.g., lockbox accounts), requiring an interest reserve or possibly retaining negotiating leverage for future transactions. It goes without saying, but as more borrowers will likely come to lenders seeking accommodations and waivers in the coming months, lenders should be aware of the short-, medium- and long-term effects such accommodations will have on their respective portfolios.
While lenders may be in a position to loosen some requirements, borrowers have well-defined obligations under existing loan agreements that they must adhere to as a starting point. Borrowers should immediately review existing credit arrangements, especially ongoing covenants, representations and warranties (or representations and warranties that will be made in connection with a new draw on an existing facility) and MAE clauses, in an effort to anticipate possible default triggers under outstanding loans or challenges in meeting the borrowing conditions for new draws. During these times of financial stress, borrowers should pay particular attention to their reporting obligations, lenders’ inspection rights, financial covenants and notice requirements. For example, the COVID-19 outbreak could cause a steep reduction in EBITDA for some borrowers, which would adversely affect most financial covenant incurrence tests, making it harder for them to make use of their baskets for additional debt and investments at a time when they most need the flexibility. Also, for asset-based credit facilities, borrowers should carefully review their advance rates and borrowing base components and anticipate any current or future problems with accounts receivable, supply chain or inventory disruption, etc. that might adversely affect their availability under the borrowing base, and thus their accessible credit. Borrowers should also closely monitor any notice requirements on an ongoing basis and be sure to remain in compliance. Almost all credit agreements require borrowers to notify lenders of anticipated litigation, MAEs, defaults and other material events, any of which may be on the horizon during the rapidly-evolving and ever-changing COVID-19 pandemic.

In this time of economic uncertainty, it seems prudent for borrowers and lenders alike to take a breath and “push the pause button”. By doing so, parties may avoid defaults triggered by, for example, financial covenants, and in turn better position themselves to avoid the more severe defaults, like payment and insolvency, in the near future. If borrowers closely monitor their financial outlook, follow the requirements in their credit agreements as much as possible and communicate any foreseeable issues to lenders in a timely manner, all parties will be better able to respond to this crisis in an economically viable and efficient manner.

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