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COVID-19: Considerations for Borrowers and Lenders Navigating Existing Debt Facilities

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In light of COVID-19 and the economic impact of measures taken to control its spread, borrowers are reviewing terms of existing credit facilities to help weather uncertain times, and lenders are surveying their loan portfolios and weighing how to manage existing relationships.

Tapping unused availability

As it became clear that COVID-19 would cause a material disruption to the economy, borrowers have been reviewing conditions to draw under existing facilities. **Public companies announced plans** to take down available credit to increase reserves. **Venture capital** and private equity investors alike have been encouraging portfolio companies to reassess budgets and forecasts and access available debt capital.

In a drawdown request for unused commitments, borrowers will have to review conditions to advance under their credit facility, which typically include:

- **No material adverse effect** – The economic impact of COVID-19 will depend significantly on the specifics of a business and with a rapidly evolving situation, the likely impact is yet unknown; in the meantime, borrowers with unused commitments should review the details of any MAC contingency and share with their lenders any plans in place to mitigate any anticipated adverse impact of COVID-19
- **Bringdown of representations and warranties** – A draw typically requires bringdown of representations and warranties (except to the extent they relate to a specific prior date). Most credit facilities were documented without considering the possibility of a pandemic. It is worth giving reps and warranties required to be reaffirmed a fresh look in light of the pandemic and its effect
- **Compliance with covenants/no default or event of default** – Here too, a fresh read of terms negotiated in pre-COVID-19 times is warranted. If there is an impending event of default caused by COVID-19 related disruptions, due to breach of financial covenants or otherwise, borrowers would be well advised to be proactive and discuss adjustment to covenants or other relief with lenders

Financial milestones and covenants

Financial milestones included in credit facilities may unlock additional availability, defer or reduce required principal repayments or excess cash flow repayments or exempt borrowers from complying with more stringent facility terms such as reporting or management of formula revolving lines. Financial covenants, if calibrated correctly at origination, will serve as an early warning sign that something went sideways relative to the plan the lender underwrote. In evaluating COVID-19's impact on the ability of a borrower to meet a financial milestone or likelihood of a financial covenant default, not only on how the particular borrower is affected by virus related economic disruption will matter, but also the deadline for meeting such milestone or frequency of testing for any financial covenant and the measurement period for the financial metric at issue. For EBITDA-based covenants and milestones, parties should review allowed EBITDA add-backs and consider the extent to which any permitted add-backs for extraordinary, non-recurring losses, charges or expenses would apply to losses and expenses associated with COVID-19 and a borrower's response to the outbreak. Many credit facilities provide for quarter financial covenant tests, with monthly reporting due 30 days following the fiscal quarter end, which would have a lot of borrowers deliver compliance certificates showing non-compliance with financial covenants on April 30, but borrowers should not wait until then to begin discussions with lenders to assess whether and on what terms covenant relief may be available. By having these conversations early, borrowers and lenders can avoid surprises and allow as much lead time as possible to for borrowers to restructure, refinance or seek other sources of liquidity. If covenant relief is not available, borrowers will need to consider the impact on any fiscal audit and associated going concern analysis.

Borrowing base impacts

For borrowers with revolving lines where availability is determined by reference to a borrowing base formula where inputs are accounts receivable, inventory or recurring revenue, borrowers will need to consider the impact of COVID-19-related disruptions on their borrowing base. Borrowing base assets may simply decline with a dip in financial performance, but for certain borrowers affected by customer cancellations and disputes in connection with measures to combat the COVID-19 outbreak, or if customers themselves struggling to manage liquidity seek to stretch payment terms beyond the permissible number of days under relevant borrowing base criteria, or for borrowers with physical inventory affected by supply chain disruptions, a decrease in borrowing base may create an overadvance, and in light of tightening liquidity, some facilities will trigger more stringent limitations on cash management and closer management of the borrowing base.

Reporting and notifications

Borrowers should review required reporting and notice requirements, which, in relevant part, often include:

- Updates to budgets or financial projections
- Disputes or claims asserted against borrower (and sometimes also by borrower)
- Changes to material agreements or commercial relationships
- Board decks

Events of default

As the impact of the spread of COVID-19 unfolds, borrowers and lenders should monitor credit facilities for events of default, including based on:

- Breaches of financial covenants
- Cross-defaults to other indebtedness or material agreements
- Deterioration in financial condition resulting in material adverse effect, insolvency or payment default

For loans that are underwritten in large part based on the support of the venture capital investor or private equity sponsor, borrowers should anticipate that lenders will want to update their assessment of the investor/sponsor's continued support of the borrower.

The impact of the COVID-19 outbreak will depend on the nature of the business. Whether the consequences will in any case be so devastating to warrant a determination of material adverse effect and whether a lender would be comfortable to rely on such determination as the sole basis of an event of default is yet to be seen. Our hope is that open communication by the parties avoids surprise and buys time to permit an orderly restructuring, refinancing or alternative transaction to raise capital.