Viral Issues for Commercial Finance Lenders and Borrowers

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The pandemic crisis unfolding in the United States and around the world has placed a significant strain on commercial lending relationships, and the pressure will only mount as the medical and financial ramifications unfold. For many companies, the immediate concern is of course liquidity. But in the face of falling revenue, shuttered businesses and extreme uncertainty, lenders and borrowers will need to make some tough choices when it comes to their ongoing lending relationships. This alert identifies and examines some of the key issues and challenges to be taken into consideration when weighing these choices.

LIQUIDITY ISSUES

To maximize liquidity for continued business operations, many borrowers have already begun, or will want to start, drawing on their available credit. So far most lenders have been accommodating these draw requests. However, the COVID-19 crisis raises some unique issues as to whether a borrower can satisfy the borrowing conditions under its loan agreement. One of the primary issues raised is whether the borrower can make the representation with respect to no-material-adverse-change (MAC) or no-material-adverse-effect (MAE), which is generally required any time a borrowing is requested.[1] The specific provisions of the loan agreement will determine the applicability of this representation.

MAC Borrowing Representations

The no-MAC representation may include a prospective, forward-looking aspect (e.g., where the "*prospects*" of the borrower are taken into consideration, or whether the event "*could reasonably be expected*" to result in a MAC). For a prospective representation, a no-MAC rep may be difficult to make. However, if the language of the no-MAC rep is limited to the present (i.e., that no-MAC has yet occurred), then a no-MAC rep will be easier to make and accept, at least in the short term. In any case, the burden will be on the lender to demonstrate that a MAC has occurred or is likely to occur.

Any determination of a MAC should be based on the most objective criteria available—rather than a subjective determination of general insecurity or uncertainty by the lender. By way of example, the lender should consider:

- Status of the borrower's operations
- Status of the borrower's vendors and customers
- Historical financial results compared to current cash flow and projections

[1] For purposes of this alert, all references to a MAC include a MAE.

- Statements/admissions by the borrower as to its financial condition and that of its customers and vendors
- Breaches of other material agreements by the borrower or counterparties

In general terms, a MAC event must have a significant adverse effect on the borrower's business such as a steep decline in cash flow (EBITDA), revenue or the like. In addition, the adverse effects must occur over a significant period of time, which could be several months or longer. Note that many MAC provisions exclude events that do not affect the borrower in a manner disproportionate to the effect on the borrower's industry or the economy (i.e., the effects must be company-specific). As we are still in the early stages of the COVID-19 crisis, the existence or prospective occurrence of a MAC based on the crisis will be a problematic determination for both lenders and borrowers.

Other Borrowing Representations

Another important aspect of the borrowing conditions during the COVID-19 crisis is the general date-down of all the other representations (and disclosure obligations) in the loan agreement, including those made at the inception of the loan.

In addition to the no-MAC rep, the following representations (and disclosure obligations) are usually required when a borrowing is requested:

- No litigation or other proceedings
- No breach of material contracts (e.g., counterparties asserting force majeure excuses for non-performance)
- No defaults (e.g., reporting, financial statement deliveries, financial covenants, cross defaults)
- Disclosure of material events (including with respect to financial condition and any MAC)
- Solvency of the borrower

Given the overarching implications of the COVID-19 crisis, these representations (and disclosure obligations) should be closely examined before any additional advances are funded. Furthermore, some of these representations (and disclosure obligations) may be qualified by the existence or prospective occurrence of a MAC, leading back to the issues discussed above.

Note too that the representations (and disclosure obligations) are also made at other times during the term of the loan, including at the time the compliance certificate is delivered and whenever an amendment or modification to the loan agreement is made.

Consequences of Loan Advances

A consequence of drawing down available credit may be to "spring" financial covenants into effect. Also additional borrowings may trigger dominion of funds by the lender, an increase in interest rate margins, an increase in certain loan fees, limits on conditional permitted payments (e.g., dividends, investments, debt repayment or prepayment), and more frequent borrowing base certificates, collateral reports and appraisals. Conditional permitted payments may also require compliance with a test, which may fail due to the additional debt resulting from such draw downs (after netting loan proceeds held by the borrower, if such netting is permitted).

Other Liquidity Sources

Another source of liquidity for a borrower may be asset sales or sale and leaseback transactions. Often these are subject to specific conditions in the loan agreement such as arms-length and fair market value terms, and no defaults being in existence or resulting from such transactions. Also, the proceeds of such transactions may be subject to prepayment provisions (including excess cash flow sweeps). Waivers or amendments of applicable mandatory prepayment terms may be required for the borrower to generate liquidity from these sources.

Many loan agreements also include other potential sources of debt liquidity, such as:

- Accordion provisions (generally uncommitted)
- Additional debt baskets (may be limited by accordion caps)
- Permitted debt baskets based on compliance with a financial ratio test (typically a ratio of EBITDA to certain types of debt)
- Debt baskets allowing conditional permitted payments capacity to be used instead to incur additional debt
- Additional permitted debt based on a percentage of equity proceeds
- Debt of parties who are not obligors (i.e., borrowers or guarantors) which often includes foreign subsidiaries
- Baskets for securitizations or other monetization of accounts receivable, chattel paper and similar assets
- Disqualified stock proceeds baskets

Such additional liquidity from debt may require the use of corresponding lien carve-outs to permit such debt to be secured. Typically, a loan agreement will include lien baskets that follow related debt baskets, such as:

- Debt under an accordion
- Other credit facilities debt

- Purchase money and sale-leaseback debt
- Asset securitization debt

DEFAULT ISSUES

The occurrence or potential occurrence of defaults resulting, directly or indirectly, from the effects of COVID-19 will likely be the most urgent issue after the borrower's immediate liquidity concerns are addressed. At this stage, compliance with loan agreement terms and the effects of reduced cash flow (EBITDA) and net income should be reviewed, projected and modeled. Note that it may take a month or longer until the crisis-related effects on the borrower's business are reflected and reported in its financial statements and compliance certificates, and crisis-related challenges to providing such reports may cause additional delays. Furthermore, as a consequence of the crisis, auditors may add going concern or other qualifications to financial statements, and these qualifications may constitute a default under a loan agreement.

Financial Covenants; EBITDA and CNI Addbacks

Both incurrence and maintenance financial covenants require the borrower to meet certain financial tests such as leverage ratios, fixed charge coverage ratios, or minimum EBITDA amounts. Maintenance covenants are tested at the end of each month or fiscal quarter. Incurrence covenants are tested on a pro forma basis prior to specific events such as conditional permitted payments of distributions or debt, or making investments or the disposition of assets. Some agreements have "springing" financial covenants which are tested only if the outstanding loans exceed some threshold amount or some other trigger has been met. As mentioned above, a consequence of drawing down available credit will be that some of these covenants spring into effect. Both lenders and borrowers should review these springing covenants and their respective triggers and thresholds.

Extensive addbacks to the calculation of EBITDA and consolidated net income (CNI) have become commonplace. These may act to mitigate the effects of COVID-19 on the borrower's financial covenant compliance and conditional permitted payments tests. The unique and extraordinary costs and expenses incurred in connection with the crisis may qualify as addbacks. Arguably it is just such extraordinary expenses that addbacks are intended to include, but the specific loan agreement terms must be reviewed and would control.

Applicable EBITDA addbacks and adjustments include:

- Non-recurring, one-time or unusual charges

- Addbacks for lost revenue or goodwill impairment[2]
- Costs and expenses incurred or anticipated with respect to restructuring operations, including in connection with excess inventory, furloughed employees, supply chain problems, and write-downs of intangible assets

Crisis-reduced EBITDA and CNI and addbacks are not short-term issues as the financial covenants and other provisions of loan agreements generally measure EBITDA or CNI on a rolling basis, typically over a trailing twelve-month period. Reduced EBITDA and CNI over the next two or three fiscal quarters will affect these loan agreement provisions well into next year.

Borrowing Base Eligibility Criteria
Asset based loans (ABL) may require an examination of the collateral eligibility criteria in light of possible stretching of payment terms to customers, concentration and cross-aging issues, account debtor solvency, and the build-up of inventory. Stress on an ABL borrowing base may impose more frequent reporting (e.g., weekly borrowing base certificates), springing cash dominion, stricter negative covenants (e.g., debt, lien and investment) and springing financial covenants.

Other Defaults
Other events of default in a loan agreement that will likely come into play include bankruptcy and insolvency defaults, which may have early triggers based on balance sheet insolvency, a borrower admitting its inability to pay debts, or a borrower having discussions with creditors about concessions, any of which could result in an event of default. Also some loan agreements include a MAC event of default (separate from the no-MAC rep), leading back to the issues discussed above. As mentioned above, auditors' qualification financial statements may give rise to defaults, and the inability of auditors, and therefore borrowers, to timely prepare and deliver financial statements due to crisis related restrictions may also constitute defaults.

<u>SOLUTIONS</u>
In light of these issues and challenges, what can lenders and borrowers do? Short-term approaches may take the form of limited waivers of defaults, and the deferral of interest and/or principal payments (including mandatory prepayments).

Pre-Workout Actions
Upon learning of a borrower's adverse developments, including the existence of possible defaults, some measured, objective assessment of the situation is appropriate. A key initial issue for a lender may be

[2] Addbacks for lost revenue should be closely reviewed and may warrant challenge by lenders since lost revenue generally does not qualify as a "loss" under GAAP.

confirming that its collateral is safe; i.e., are the borrower's business premises secure, have the insurance premiums been paid?

Before undertaking discussions of waivers or other short to intermediate term actions, a reservation of rights letter, followed by a pre-workout or pre-negotiation agreement, may be prudent to protect the lender. The reservation of rights communication informs the borrower that the lender is aware of facts or defaults described in the letter, and the lender reserves all rights with respect thereto. The lender may also wish to set a deadline for the start of substantive discussions.

The reservation of rights may be followed by a pre-workout or pre-negotiation agreement. That agreement would set out the agreed-upon process the parties will follow to discuss the situation, including protocols for communication, without prejudice to their rights. Under such agreement, the discussions will not be admissible in any litigation.

Forbearance Agreements
If an immediate waiver and/or amendment isn't appropriate, perhaps due to the uncertainties of the situation and unpredictability of the crisis fallout, then a forbearance agreement may be a better approach. In contrast to a waiver and amendment, a forbearance arrangement preserves the lender's rights under the existing circumstances.

A forbearance agreement will include a statement of mutually agreed facts (e.g., loan balances, existing defaults), a limited forbearance by the lender from exercising some or all of its remedies, and set out milestones, with deadlines, for the borrower to accomplish in order to continue the lender's forbearance. If any milestone deadlines are missed, or new defaults occur, the forbearance is automatically terminated, and the lender and borrower can negotiate to reset the forbearance on new terms, or the lender can start exercising its rights and remedies under the loan agreement and otherwise available at law.

The forbearance agreement will typically include other lender-protective provisions such as cash dominion and general releases. A forbearance agreement may also be combined with an amendment to implement certain agreed upon loan modifications while also stipulating milestones required for further concessions.

Waivers and Amendments
Many problem loan situations can be addressed by waiver and amendment to the terms of the loan agreement. This may be as simple as adjusting the payment terms and financial covenants to fit the new reality based on waivers of defaults arising from the COVID-19 crisis.

Alternatively, the process may require a more complicated restructuring of the company's debt. For longer-term corrections, amendments or more extensive documentation may be needed to address permanent changes to a borrower's business (e.g., some covenants may not be applicable or appropriate post-crisis; or the debt may need significant restructuring).

Waiver and amendment accommodations that a lender might offer for the short to intermediate term may include:

- Extend deadlines for financial reporting, certificates and other deliverables by 30-60 days, and in a syndicated facility permit the agent to unilaterally extend such deadlines even further
- Permit COVID-19 related going concern qualifications to financial statements for the next year
- If overadvances exist or are expected to occur because of borrowing base ineligibility of accounts receivable or inventory, waiver of the required immediate debt repayment, but also cease or limit additional advances
- Allow equity cures to be used to remedy covenant breaches, such as by boosting EBITDA, perhaps allow dual application of cure payments to reduce both debt and increase EBITDA, and increase the number of cure rights that may be exercised
- Allow additional equity infusions without any associated required loan prepayment
- Convert incurrence or springing maintenance financial covenants to straight maintenance covenants, adjusted as appropriate with respect to the anticipated effects of the crisis
- Adjust EBITDA and CNI addbacks with appropriate caps and time limits
- Tighten covenants to limit so-called “liability management” schemes, such as asset transfers to, or investments in, non-loan parties

With respect to financial covenants, a lender might agree that such covenants will be calculated excluding the pandemic-affected periods, acknowledging that the effects are outside the projections and models that either party considered in setting the covenants. Or a lender might simply provide a covenant holiday for the affected period.

Similarly, with respect to other covenants and representations, the lender might agree to eliminate or adjust the no-MAC rep and related representations and covenants to back out the pandemic effects. Likewise, the lender may agree to waive or amend covenants in order to permit a borrower to participate in the government assistance loan programs under the CARES Act.

The accommodations a borrower might offer to obtain a lender’s forbearance or loan modification could include:

- Additional collateral consisting of any unencumbered assets or liens that may be subordinated
- New credit support such as guarantees
- Increased pricing (including PIK interest and fees)

- Additional or tighter financial covenants and permitted payments/actions tests
- Additional reporting

Today lenders and borrowers face unprecedented challenges in their commercial finance relationships. These challenges can be overcome with patience, perseverance and creativity. Buchalter has deep and longstanding commercial finance, workout, restructuring and insolvency expertise, including the largest creditor-focused insolvency and reorganization practice on the West Coast. Please contact us if we may be of assistance.

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