A Borrower's Response to COVID-19

Written by Thomas Draper

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What should a borrower be doing about its credit facility as a result of shut-downs and loss of revenues from the COVID-19 disruptions? The borrower's primary concern is to ensure sufficient liquidity, particularly if the disruptions are likely to last for months. In addition, the borrower should prepare for future defaults and the possibility of an eventual insolvency.

Liquidity

In light of COVID-19 disruptions, many borrowers are drawing down the maximum amount of their revolving credit facilities (and deferred draw term loans). This action ensures maximum liquidity at a time when the borrower still remains in compliance with its credit facility obligations. At a future date, the borrower may be unable to obtain loans if COVID-19 disruptions cause it to fail its financial ratio covenants, typically leverage (debt to EBITDA) or fixed charge coverage (EBITDA to debt service, capital expenditures, taxes, etc.). In addition, current low interest rates (prime at 3.25%; LIBOR at approximately 1%) make additional borrowing unusually attractive.

The maximum amount that can be borrowed may be limited by a borrowing base, under which outstanding revolving loans cannot exceed specified levels of eligible accounts receivable and inventory (or in some cases, EBITDA). Similarly, some credit agreements prohibit borrowings that would cause outstanding loans to exceed permitted leverage levels on a pro forma basis. Even "covenant-lite" credit facilities often have a springing leverage test that must be satisfied only when outstanding revolving loans exceed a percentage (often 35%) of revolving loan availability. Finally, most credit agreements do not permit further borrowings if a "Material Adverse Effect" has occurred.

Material Adverse Effect

As a condition to borrowing, most credit agreements require that no material adverse effect has occurred with respect to the business, assets, operations or condition (financial or otherwise) of the borrower and its subsidiaries (taken as a whole), or with respect to the borrower's ability to perform its obligations under the credit agreement. While court decisions as to what constitutes a material adverse effect for purposes of a credit agreement are extremely rare, in the acquisition context courts have been very reluctant to determine that a material adverse effect has occurred that would permit a party to terminate a proposed acquisition. Most courts rule that such an event must be severe in nature and significant in its duration (extending for several financial quarters). The exact language of the material adverse effect provision is critical.

In credit agreements, some material adverse effect provisions refer to a borrower's prospects or other forward-looking criteria that might increase the likelihood that a court would conclude that such an event has occurred. In addition, credit agreements typically do not include exclusions that are customary in acquisition agreements, such as acts of God, terrorism, war, general economic conditions, etc. On balance, however, lenders have been historically reluctant to rely on a material adverse effect clause to refuse to fund a borrower that is otherwise in compliance with its credit facility obligations. Legal counsel should be consulted with respect to a borrower's particular circumstances.

Other Defaults

Apart from liquidity issues, COVID-19 disruptions may be anticipated to result in the inability to satisfy certain covenants in the future and thus result in an event of default. Most likely, a borrower may anticipate that the loss of revenues and earnings will result in its inability to comply with required financial ratio levels for future quarterly reporting periods. Unlike supply agreements and licenses, credit agreements do not typically excuse borrower noncompliance for force majeure or hardship events. Most EBITDA definitions contain an exclusion for nonrecurring, unusual or extraordinary items, but it's not clear that the present COVID-19 disruptions would satisfy the historical interpretation of those events for accounting purposes. Other potential defaults might include the occurrence of a material adverse effect (see discussion above) for those credit agreements that contain such a clause and mandatory prepayments resulting from outstanding revolver loans exceeding a borrowing base that has been reduced by declining accounts receivable. Some borrowers will not be able to produce timely audited financial statements because their accountants are no longer making site visits.

For borrowers anticipating the occurrence of future defaults, the best course is typically to maintain steady and open communication with the lender about these issues. This dialogue will enable the lender to have confidence in the borrower's disclosures and proposed business plan and collaborate with the borrower to negotiate steps that alleviate credit risks.

Shift of Duties in Insolvency

Under Delaware law, a company's board of directors and officers typically owe a duty only to the company's shareholders. If the company becomes insolvent, however, this duty shifts to include other claimants, typically creditors, as well as shareholders. Delaware courts do not apply this shift in duty for a company in a preliminary "zone of insolvency", but require that an actual insolvency exist. Insolvency is determined under any one of three tests: (a) balance sheet (fair value of assets exceeds liabilities), (b) cash flow (ability to pay probably liability on obligations as they mature) and (c) capitalization (company does not have an unreasonably small capital for its operations). Even for an insolvent company, directors and officers are generally protected if they act in good faith to promote the increased value of the company. However, considerations with respect to insolvency are very complex and technical; legal counsel should be consulted.

For timely updates and guidance on your COVID-19 issues, visit the **Foley Hoag COVID-19 Resource Page**.

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