Shumaker, Loop & Kendrick, LLP

Client Alert

Business Information for Clients and Friends of Shumaker, Loop & Kendrick, LLP

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Commercial Loan Documentation: Effects of COVID-19

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The fallout from the World Health Organization-declared global pandemic arising from the corona-virus disease ("**COVID-19**") is currently having, and will certainly continue for some time to have, severe impacts on almost all aspects of life, including the operations and profitability of most businesses. The negative impacts of the disease itself include lost productivity and rising aggregate health care costs, including straining already finite health care resources, and the economic and intangible stresses on families and individuals directly affected by COVID-19. In addition, these "direct" negative impacts are potentially magnified in the short-term by the unprecedented responses from multiple levels of government encouraging or requiring, among other things, varying degrees of social isolation designed to stem the spread of this fast-spreading and potentially deadly virus. These policies designed to protect the public health in the long run, will almost certainly have a significant cost in the short run, including disruption of the supply-chain in many sectors and significant slow-downs in productivity across most sectors of the economy, such as manufacturing and delivery of goods and services, reduced demand for both goods and services on a world-wide basis, combining to result in the inevitable slowing of many sectors of the domestic and international economy, which will likely result in a global recession. Almost all businesses and borrowers are or will be adversely affected by this anticipated slowing of the economy, which, at least in the U.S., was being hailed as nearly "recession-proof" by one major investment bank only two months ago[1].

The seemingly sudden turn of events brought on by COVID-19 creates many issues for participants in the credit markets. As the economy slows down, and in some industries potentially comes to a halt, many commercial borrowers are likely to (or will) experience a significant reduction in cash flow, erosion in asset value, operational and structural issues, or other situations that have a material adverse effect ("**MAE**") or constitute a material adverse change ("**MAC**") with respect to such borrowers, and/or resulting in their inability to comply with financial covenants and other provisions of their commercial loan documentation.

Time to Review Loan Documents

Now is the time for lenders and borrowers to carefully review their loan documents to determine to what extent borrowers may be, or are likely to become, in default of financial covenants or in breach of representations and warranties or other covenants, or are required to provide notice to their lenders of their current or anticipated circumstances. Additionally, borrowers should evaluate their ability to draw on credit facilities in order to provide working capital and meet short-term liquidity needs, and lenders need to evaluate their commitments and to what extent they are required (or, if not required, willing) to fund on such commitments. The purpose of this Client Alert is to review some of the issues that are likely to arise as a result of the current crisis.

Financial Covenants

Most commercial loan documentation contains one or more financial covenants including (i) cash flow covenants, such as a debt service coverage ratio, a fixed charge coverage ratio, or an interest coverage ratio, (ii) leverage ratios comparing total debt to cash flow, (iii) liquidity covenants, such as availability of unencumbered cash or cash equivalents, marketable securities, receivables and inventory, and/or (iv) net worth covenants. Additionally, in commercial real estate lending, loans are typically also subject to loan-to-value and/or loan-to-cost covenants, which limit the principal amount of the loan to a percentage of the fair market value of the underlying real estate or the cost of acquisition and completing improvements on such real estate. Most cash flow covenants in the commercial loan (non-real estate) world are based on an EBITDA (earnings before interest, taxes, depreciation, and amortization) definition (which may be on a consolidated basis with a parent and its subsidiaries), often subject to certain negotiated add-backs or other adjustments.

In the real estate loan context, cash flow covenants are typically based on a net operating income formulation, which is generally based on the gross revenue derived from the operation of the property less its operating expenses, management fees, and often capital reserves. Financial covenants are generally tested periodically, most often as of the end of each fiscal quarter on a trailing 12 month basis (thus looking backward at historic performance of the borrower (and its consolidated group)). As a result, and because of the timing of the COVID-19 outbreak in the U.S., there may not be a significant impact for covenant testing as of the quarter ending March 31, 2020. However, starting with the second quarter of 2020 and onward for the duration of the COVID-19 pandemic, it is likely that the financial results of many borrowers will be adversely impacted which could compromise such borrowers' ability to maintain compliance with their various financial covenants, placing them at risk of triggering a default under their loan documents.

Payment Defaults

In addition to potential so-called "technical" breaches of representations, warranties and covenants under current loan documents, the operational disruptions and financial stresses on borrowers as a result of the COVID-19 pandemic discussed above, including reduced revenue, raw material shortages, weak demand for products and services and potential increased costs in preparing and implementing COVID-19 mitigation policies, create a substantial increase in the risk of actual payment defaults and other such fundamental defaults under loan documents, which is of greater concern than the "technical" breaches described above which, after all, are designed to provide early warning of issues that could ultimately lead to payment defaults.

Borrowing Bases/Asset Values

Additionally, erosion of asset values or depletion of available resources, resulting from supply chain disruptions, or as a result of customers' inability to timely pay accounts receivable, will likely have an adverse impact on borrowing bases, thus, limiting the ability of borrowers to access their credit facilities in order to provide needed working capital in the face of increased cash flow stress. In the real estate lending context, borrowers whose real estate becomes devalued because of declining rental or operational revenues will have difficulty complying with ongoing loan-to-value covenants that require a minimum value in order to maintain the outstanding loan balance.

Representations and Warranties

Loan documentation should also be evaluated to determine to what extent representations and warranties are continuing or whether they are static as of a time given. Most often, credit facilities that provide for ongoing borrowing, including lines of credit, multiple draw term loan facilities, and construction loans will require representations and warranties to be true and correct as of each borrowing, while with many single advance term debt obligations, representations and warranties may only be made or deemed made as of the date of the original closing and/or funding of the loan. Additionally, events of default or defaults (conditions that could become an event of default after notice or running of cure periods), or the occurrence of an MAE or MAC typically act as a "draw stop" with respect to the lender's obligation to fund subsequent committed borrowings under multiple draw facilities, enabling the lender to refuse to fund a committed loan at a time when the borrower is likely in most need of liquidity to fund working capital. Thus, it is important to understand what exactly constitutes an "event of default" under the loan documents in question. It should be noted that this could include obligations or contracts outside of the credit facility itself, and might include defaults under the borrower's material contracts, other loans or guaranties. MAE and MAC definitions should also be reviewed in light of the new COVID-19 reality as these provisions can be relatively generic or they may be the subject of heavy negotiation at the loan documentation stage. Some such clauses may exclude from their effect certain events that would typically be classified as "force majeure" in other contexts and, if so, may, depending on how drafted, exclude epidemics and pandemics. Therefore, it is important to evaluate such provisions to determine whether the borrower is required to make disclosures to its lender. Often there can also be fine distinctions between whether a particular set of circumstances is <u>certain</u> or <u>might</u> trigger a MAE, and it is thus important to carefully review the particular language at a granular level and understand such distinctions. It is likely that the impact of COVID-19 on certain borrowers will result in a representation and warranty being untrue, having an MAE, or arising to the level of an event of default, any of which would prohibit a borrower from being able to access its credit facility under the applicable loan documentation and may result in requirements to disclose and potentially trigger an event of default and lender's right to accelerate the loan and declare all outstanding amount immediately due and owing.

Notices Required by Borrowers

Commercial loan documentation also generally imposes certain obligations on the borrower to provide notice of certain events or occurrences. These provisions are in addition to any continuous or re-upping of representations and warranties or delivery of any certificates as a condition of a borrowing. Generally, the requirement to include notice will include notice of pending or threatened litigation, any MAC, or any event that would result in an MAE, all or any of which may be implicated by the effects of COVID-19 on a borrower, its business, assets, finances, or potentially prospects.

Force Majeure

Although generally not used outside of construction lending, loan documentation may provide for "force majeure" provisions that limit the borrower's required performance under the documentation for certain specified events. However, it should be noted that such force majeure provisions do not typically cover actual monetary obligations nor do they excuse a borrower from making required payments. As noted, such provisions are typical in construction loan agreements, and excuse failures to continue construction or delays in completion of construction by a date certain as a result of certain specified events. Such events are typically "acts of God" or other circumstances beyond the control of the borrower, such as acts of war, terrorism, inability to obtain materials (which clearly might be impacted by the current supply chain issues resulting from COVID-19), strikes, or other labor lockouts or disputes. Whether a pandemic, such as COVID-19, would qualify under a force majeure clause will be dependent on the specific language of the clause. Some clauses may specifically contemplate pandemics, epidemics, public health emergencies, or declared national emergencies, each of which would appear to cover the current pandemic.

Potential Solutions

Both borrowers and lenders should review their loan documentation and be proactive in addressing the myriad of issues that will result from this crisis. Borrowers should particularly review what notices they may be required to give their lenders. Even if anticipated issues are not technically currently required to be disclosed, borrowers may wish to consider informing their lender of the likely impact COVID-19 may have on their business to explore collaborative solutions to anticipated problems in the months ahead. Such proactive voluntary disclosure may encourage lenders to "partner" with their borrower-clients to address financial and cash flow stress and search for a solution that potentially protects each party's respective interests. For instance, lenders can amend financial covenant ratios in advance with step ups over several periods to the current baseline or, to the extent borrowers have available cash, they may wish to consider whether it makes sense to exercise any equity cure rights, or to add such a cure right if none exists, in order to bring them into compliance in the event of a financial covenant breach. Lenders will also need to consider extended time periods for a borrower to make an equity cure or alternatively allowing borrowers to net or apply cash on the balance sheet with respect to cash flow and leverage covenants.

What We See Ahead

As noted above, the repercussions and disruptions of COVID-19 and government and private actions in an attempt to stem its spread will be pervasive throughout society and commercial relations, and will result in severe economic pressure on borrowers, as well as their ability to fully comply or perform in accordance with the terms of their loan documents. Given the pervasive nature of the impact of COVID-19 across the economic spectrum, increasing levels of defaults, if enforced, would likely result in significant losses among lenders, and declining values of collateral securing non-performing loans. Certain industries, including travel, hospitality, dining, entertainment, bars, and bricks and mortar retail are already under extreme duress and will likely suffer long term adverse impacts, including insolvency proceedings. Other industries, such as manufacturing, will likely suffer more short-term issues, but will likely recover as supply chains are restored and demand rebounds after the virus is brought under control. This particular crisis is different than other financial crises of the past. U.S. financial regulators have made it clear that regulated financial institutions "should work constructively with borrowers....in affected communities" and that "[p]rudent efforts that are consistent with safe and sound lending practices should not be subject to examiner criticism"[2]. Thus, responses of creditors to borrowers for covenant and loan defaults likely will be more measured, collaborative, and softer than in previous financial inflection points. Waivers of covenant compliance or reduction in covenant thresholds (at least on a short-term basis), short-term EBITDA add-backs, borrowing base relief, forbearances, interest rate reductions, payment deferrals, and maturity extensions, among others, will be tools to be used in addressing these defaults or potential defaults.

In addition, lenders will be faced with the challenge of developing enhanced diligence tools to assess and negotiate proposed terms of modifications and waivers, as well as structuring new commercial loan transactions, where even consistent and/or recent historical financial results may be of limited value in modeling projections in the coming months or longer. As economic data becomes available and individual borrower performance in the new (hopefully short-term) reality during the pendency of the COVID-19 pandemic reveals itself, lenders will need to constantly refine and update these analysis tools to stay both competitive and within prudent credit risk parameters.

Shumaker's Financial Services practice group has extensive experience in representing both financial institutions and commercial borrowers in a variety of transactions and structures, in all areas of commercial lending. Please contact us if you have questions regarding this Client Alert or if we can be of assistance in reviewing loan documentation and advising of potential courses of action.

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[1] Cox, Jeff, "Don't look now, but Goldman Sachs is saying the economy is nearly recession-proof", December 31, 2019, 11:56 AM EST, updated January 2, 2020, 9:07 AM EST, www.cnbc.com/2019/12/31/goldman-sachs-is-saying-the-economy-is-nearly-recession-proof.html

[2] See, Joint Press Release of Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Current, and Conference of State Bank Supervisors, March 9, 2020, 4:30 p.m. EDT, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200309a.htm