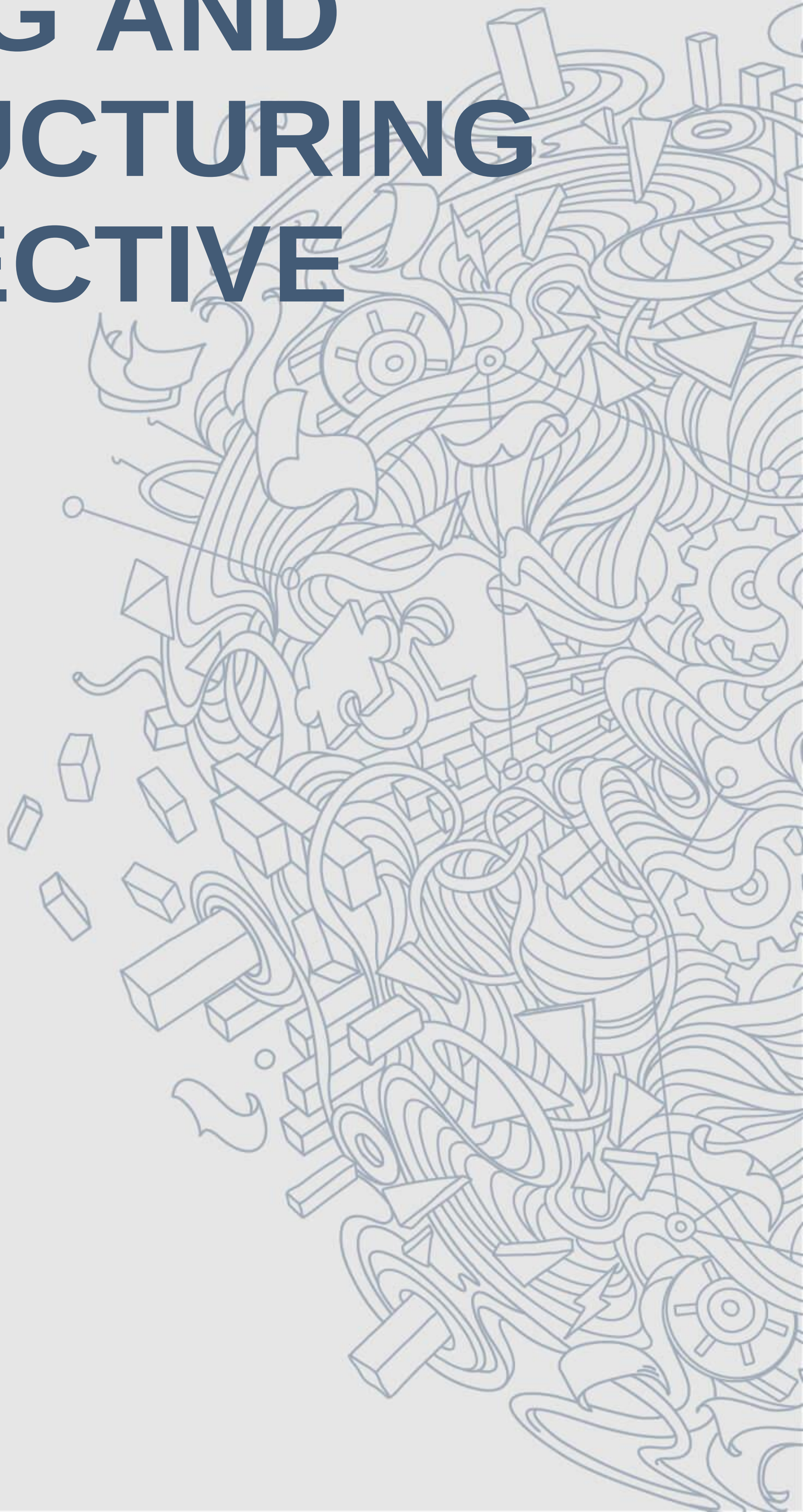
COVID-19 PANDEMIC – A LENDING AND RESTRUCTURING PERSPECTIVE



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LENDERS AND BORROWERS ARE CONSIDERING THE EFFECT OF THE COVID-19 PANDEMIC ON FUNDING ARRANGEMENTS. WHAT SHOULD THEY LOOK OUT FOR AND WHAT PRAGMATIC STEPS COULD THEY TAKE?

On 11 March 2020, the UK Government delivered its Budget for 2020, which addresses in part the Government's short-term economic response to the impact of the COVID-19 pandemic. This included focused support for impacted SMEs: *'business interruption*' loans of up to £1.2m, the abolition of business rates for retail, leisure and hospitality sectors with a rateable value below £51,000 and a refund for sick pay payments of two weeks for firms with fewer than 250 staff.

Separately we have seen the creation of 'support funds' by certain clearing banks to support customers' liquidity, and the Bank of England's announcement that interest rates would be cut from 0.75% to 0.25%.

It remains to be seen how successful this initial response might prove for affected businesses, who still need to carefully consider how they maintain a stable balance sheet, alongside a sufficiently healthy cash flow where the reach of the pandemic remains uncertain. Larger firms exposed to the effects of the pandemic will also have to take note of the Government's policy, and be prepared to seek out equity and/ lending support from their stakeholder body to help bridge to a period of improved economic stability in the market. We would suggest that such stakeholders be approached on a collaborative and open basis, as soon as details for any requested support may be available.

We have seen immediate liquidity challenges in a number of sectors, including aviation, travel, hospitality, and tourism principally caused by revenue impact of people not travelling or gathering, as well as the pressure of the supply chain as stakeholders look to protect their own positions.

As such, both lenders and borrowers will be concerned with the resulting impact upon their financing arrangements, by necessity not designed to accommodate such steep drops in demand or widespread market disruption. Below we address typical concerns from both the borrower and lender perspective, and pose some pragmatic suggestions for next steps that might be considered.

NAVIGATING LOAN FACILITIES: THE POSSIBLE IMPACT OF THE PANDEMIC AND CERTAIN CONSIDERATIONS FOR LENDERS AND BORROWERS

MATERIAL ADVERSE CHANGE ("MAC") CLAUSES

MAC provisions typically allow for a lender to accelerate facilities in scenarios where the borrower is in a substantially deteriorated position than when they entered into finance documents. These provisions tend however to be heavily negotiated, and often vary in form.

Facility documentation wording will often refer to a situation where there has been a material adverse change to the business, operations, property, condition or prospects of the borrower or their ability to perform their obligations under finance documents or the effectiveness of guarantees or security. Analysis of the specific drafting of such clauses should be carried out before any party seeks to act on MAC provisions.

In the absence of a more 'objective' breach, lenders are usually reluctant to rely solely on MAC provisions as they are difficult to enforce (and are therefore more commonly cited by way of supplement to another specific breach) and are subject to the customary rules of contractual interpretation.

Typically a lender would have to prove the effects of COVID-19 will have a sustained adverse effect on the borrower's business and that the current effects on a business are not temporary and will continue for some time. Some businesses may have sufficient capital reserves and/or contingency planning in place to assist in managing the short- term market effects, although it of course remains to be seen how long the negative consequences of the virus will last.

Certain business sectors (some of which are noted above) will suffer significant stress without access to customers and suppliers, meaning their business operations may be temporarily effectively halted as a result, particularly in light of the WHO's recent confirmation that COVID-19 is now a pandemic.

COVID-19 has already found its way into the drafting of MAC clauses in corporate transactions. Documentation from Morgan Stanley's acquisition of E*Trade Financial Corp. specifically carved-out COVID-19 from the definition of MAC. It clarified that no *"[…] epidemic, pandemic or disease outbreak (including the COVID-19 virus)*" will amount to an event, circumstance, development, change, or occurrences that constitutes, or which will be reasonably likely to result in, a material adverse effect on "*the condition (financial or otherwise), assets, liabilities, business or results of operations.*"[1]

> **WE DO NOT ANTICIPATE MAC CLAUSES BEING WIDELY INVOKED BY 'TRADITIONAL' FINANCE PROVIDERS, INCLUDING BANKS. HOWEVER, THE PROLIFERATION OF ALTERNATIVE CREDIT PROVIDERS MEANS THAT THERE WILL BE SIGNIFICANT VARIATIONS IN APPROACH, WHICH BORROWERS SHOULD BE MINDFUL OF.**

James Davison, Partner, Restructuring.

Parties should also consider the terms of any equity investment documentation and whether equity commitments can be withheld or withdrawn due to MAC or similar clauses. Whilst there remains significant capital across the market for deployment and sponsor appetite has been strong, equity investors, who bear the greatest risk, are likely to be more cautious of following their money, if the effects of the pandemic are likely to significantly impact long-term returns.

WORKING CAPITAL / RCF FACILITIES

RCFs may include a draw stop provision, designed to give the lender the right to refuse making further advances (or continue to extend existing advances) in the event that there is the potential for (or an actual) event of default. If a lender is entitled to such a right, they should tread carefully as it may have an effect on the cash flow of the borrower and consequently its ability to ultimately pay down the outstanding RCF debt. The potential reputational impact on such a lender will need careful consideration, particularly in the context of the political and financial support revealed in the Government's Budget.

MARKET DISRUPTION PROVISIONS

Market disruption provisions, if present in the loan facility, may be triggered when a lender's cost of funding exceeds the interbank lending rate benchmark. With the LIBOR rate staging its biggest one-day drop in more than a decade, it is possible that these rates will start to be superseded by lenders' cost of funding in the market.

If enforced, the interest on a loan will typically be calculated on the lender's cost of funding (or average cost of funding across a group of lenders) plus a margin. Lenders should be aware that certain market finance documentation may include an ability for a borrower to revoke a utilisation request if the loan turns out to be priced on a cost of funds basis.

Market disruption clauses have not been regularly used by lenders to date in our experience as a response to loan market instability. This is in part because calculating cost of funds interest rates can be time-consuming and enforcing such rates may disturb the cash flow and financial covenants of a borrower.

In order to avoid the difficulties noted above, counterparties may consider extending interest periods and allowing borrowers to benefit from greater liquidity (and breathing space) in the short term. Lenders will nevertheless have to consider the difficult question of how long the financial impact of the virus will last and the overall level of financial support which is likely to be required in the medium-term.

[1] Bloomberg : ANALYSIS: Morgan Stanley, E*Trade Merger Excludes Coronavirus

FINANCIAL COVENANTS ('EARLY WARNING SYSTEMS')

These provisions are drafted with the intention of flagging to the lender when a borrower may be financially stressed and potentially unable to meet its financing obligations. To mitigate the likelihood of lenders seeking to accelerate immediately on a breach of such a provision, early (and ideally advance) engagement by the borrower with its lender(s) would seem more likely to result in understanding, accommodation and concessions.

> **"IT IS POSSIBLE THAT WE WILL START TO SEE COVID-19 USED AS AN 'EXCEPTIONAL ITEM' IN FINANCIAL COVENANTS TO DELAY OR AVOID A TECHNICAL BREACH OF A FINANCIAL COVENANT, ALTHOUGH THAT MAY ONLY DELAY THE INEVITABLE. IF COVID-19 MEANS THAT A COMPANY'S REAL EBITDA FALLS OFF A CLIFF, THEN ULTIMATELY THAT COULD LEAD TO HARD QUESTIONS ON WHETHER THAT COMPANY IS SOLVENT OR VIABLE**

Peter Crichton, Partner, Leveraged Finance

REPEATING REPRESENTATIONS

Borrowers will often be required by finance documents to make a number of representations to the lender. These representations might be deemed to repeat on each interest payment date, for example. They may also require the borrower to state there is no default under the loan documentation. Lenders and borrowers alike should be alive to how the pandemic could affect such representations.

REPAYMENT

The effect of COVID-19 on businesses' financial performance may affect their ability to meet scheduled repayments. As always, borrowers should plan ahead and be aware of any upcoming repayment dates. In the circumstances, they may seek to enter negotiations with lenders over whether they can defer scheduled payments or pursue wider restructurings of outstanding debt.

When parties consider repayment dates in this context, they should note that payment dates in finance documents usually fall on 'Business Days' (normally defined as days on which banks are open for general business excluding Saturdays, Sundays and sometimes public holidays). Over the past few weeks, we have seen certain jurisdictions organise additional public holidays as a means to respond to the pandemic and increase social distancing efforts. A borrower will therefore need to clarify when the repayment date falls either before or after the day of a newly announced public holiday.

CESSATION OF BUSINESS

An event of default may also be triggered if all or a material part of the borrower's business is suspended or ceases to operate. This could be particularly relevant in the travel, leisure and events management sectors (for example), where government or supranational public policy may recommend or dictate that the public are not permitted to engage with such business services and businesses may be considering 'mothballing' strategies.

NEGOTIATIONS WITH CREDITORS IN RELATION TO ACTUAL OR ANTICIPATED FINANCIAL DIFFICULTY

Loan counterparties should be aware of the impact of entering into negotiations in relation to actual or anticipated financial difficulty of the borrower.

The loan market form of insolvency event of default often captures the commencement of informal measures (such as negotiations with creditors) in relation to actual or anticipated financial difficulty. This can cover the rescheduling of any indebtedness with any single creditor, including a company’s landlords and trade creditors, regardless of the value of those liabilities. The extent to which any particular approach or negotiations with a single or class of creditors might trip this provision will however always turn on the drafting of the relevant provision.

RELATED CONSIDERATIONS

FORCE MAJEURE

Borrowers may be familiar with such provisions, which are often appear in various forms in commercial contracts. If present in a finance document, such a provision may suspend or terminate a party's obligations in circumstances beyond their control. These are explicit clauses, often using the term 'act of God' and cannot be implied. The concept of an act of God is difficult to prove although there may be further drafting relating to pandemics. Further, if there is provision for acts of Government, parties may wish to consider the steps taken by the Government so far, such as travel restrictions.

NEXT STEPS FOR COUNTERPARTIES

EARLY ENGAGEMENT

It may be in a borrower's interest to report regularly to lenders and notify them of any potential event of default as soon as they are aware, bringing them alongside business decisions and performance as it evolves. In addition to reporting obligations detailed in finance documents, if lenders are given early notice, they are often better prepared and able to respond to requests for waiver or consents to extend deadlines and negotiate more achievable terms. This will be especially pertinent in syndicated arrangements, where the process will take longer to organise voting on terms between the different lenders.

LOAN TRANSFER PROVISIONS

Some lenders may, as a means of mitigating their risk, consider transferring their debt and security. This can make matters more difficult for borrowers when trying to progress stakeholder discussions. Parties should check whether there are restrictions on transferability – e.g. to affiliates and entities on a white/ permitted list – such restrictions may fall away following an event of default.

IN SUMMARY

The COVID-19 outbreak has created significant uncertainty in global markets, for sponsors, borrowers and lenders alike. Based on our experience to date, we expect it will take a number of weeks, potentially months, for the larger term impact to be quantified. In the meantime, we expect businesses to focus on cash management and stakeholder engagement in order to achieve stability. For businesses in the worst hit sectors we anticipate there will be a need for swift and decisive support, most likely achieved through a combination of measures, across finance documents, supply chain management, costs management and sponsor support. In the words of one of our clients: "We are all in it together!".

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