Chapman and Cutler LLP

Chapman Client Alert

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Lender Considerations with Respect to Existing Middle Market Credit Facilities in Light of the COVID-19 Pandemic

While many questions and uncertainties exist with respect to the full economic impact of COVID-19 on the global economy, below is brief overview of the more prominent issues for lenders to consider in respect of existing middle market credit agreements – particularly, as a spike in amendment and waiver activity is expected in coming months.

Revolver Draws

Numerous borrowers have recently sought to proactively draw down any remaining unused revolving credit commitments in response to uncertainty and prospective liquidity concerns. As a result, many lenders have inquired as to whether any legally valid basis exists for refusals. Credit agreements typically include conditions precedent to each "credit event," including advances of revolving loans under revolving credit facilities. The conditions to each credit event commonly include a bringdown of all representations and warranties set forth in the credit agreement, as well as confirmation that no default or event of default exists at the time of the borrowing or after giving effect thereto.

Bringdowns of Representations and Warranties Prior to Borrowing – Particularly, the "no Material Adverse Effect" Representation

The most common lender inquiry in respect of the foregoing has been a determination as to whether a lender can refuse to fund a requested revolving loan on the basis of a borrower's inability to bring down the "material adverse effect" or "material adverse change" representation (often referred to as the "MAE" representation).

A common formulation of the MAE definition will provide two potential triggers that are currently relevant or may become relevant as the present economic disruption continues: (i) a material adverse effect on the financial condition of the borrower – while likely a bit premature to rely on this trigger now, this clause may become more of a hot button topic in subsequent fiscal quarters and (ii) a material adverse effect on the ability of the borrower to perform its obligations under the credit agreement – while this trigger can potentially be read to include a prospective failure to satisfy future financial covenant tests, a number of credit agreements in the core middle market and upper middle market limit this trigger solely to a material adverse effect on the borrower to perform its "payment obligations" (in such instances, short of a payment default, it may be more difficult for lenders to rely on this clause).

The drafting of the MAE representation itself can also be a key determinant in a borrower's ability to satisfy conditions to borrowing. Some variations of the MAE representation only require that there is no occurrence of an MAE as of the date of borrowing. Other more lender-favorable MAE representations include a forward-looking component, requiring the borrower to represent that since the closing date no event has occurred that has resulted in, or could reasonably be expected to result in, a MAE.

A borrower's ability to make the MAE representation is thus a fact-specific analysis that is dependent on a handful of factors, including, but not limited to: (i) how "Material Adverse Effect" is defined in the loan agreement, (ii) the circumstances known or reasonably expected at the time parties entered into the agreement, (iii) the borrower's specific type of business and whether the impact experienced is a short-term hiccup or of a longer-term duration, and (iv) whether the alleged material adverse effect substantially threatened the earnings potential of the business. Courts require lenders to bear the burden of proof in seeking to use a MAE clause to excuse a lender's nonperformance, which can be an uphill battle.

For the above-mentioned reasons, lenders should be cautious in relying upon an MAE clause to avoid funding and should consult with counsel prior to making any determination.

No Default or Event of Default Condition

Lenders should be mindful of the fact that any default or event of default – even the most technical in nature, such as a late financial report – can serve as the basis for a lender's refusal to fund a revolver draw in most credit agreements. Nonetheless, a lender needs to carefully weigh its credit risk

against the ancillary effects of refusing to fund on the basis of any technical default such as market reputation, potential litigation, and a soured customer relationship if the lender provides other banking services to the borrower, such as cash management or hedging.

Notwithstanding the conditionality required to be satisfied by a borrower prior to any revolver draw, it is important to note that many credit agreements permit either (i) each revolving lender to make an independent determination to fund notwithstanding the failure to satisfy the conditions to each draw or (ii) the required revolving lenders (without the participation of the term lenders) to waive or excuse one or more conditions to advancing funds under the revolving credit facility.

In addition, while many delayed draw term loan facilities include additional conditions for any borrowing, the above-mentioned MAE representation issues and default conditionality concerns will also apply in the context of delayed draw term loans.

Reporting Requirements

In light of the pandemic, numerous borrowers have requested extensions of the audit deadline for the fiscal year ending 2019. As a result of the drastic reduction of business travel and general shutdown of many businesses, audit staff will likely not be in a position to deliver audited financial statements by the common 3/31 or 4/30 deadlines.

Lenders should also anticipate receiving comparable extension requests with respect to unaudited monthly and quarterly financial statements in upcoming periods. Due to state-imposed lockdowns and business closures, in addition to most company financial officers working from home, it is foreseeable that borrowers may need additional time to prepare their company-produced financials.

Several lenders have implemented a uniform approach to audit extensions and monthly/quarterly extensions across their portfolios. Extension of any such deadline can generally be accomplished with the consent of the required lenders.

EBITDA Addbacks

To some degree in Q1 2020 and to a significant degree in Q2 2020 and beyond, it is expected that many borrowers will look to use adjustments/addbacks to Consolidated Net Income and/or Consolidated EBITDA to minimize the effects of the economic slowdown for financial covenant compliance purposes. Use of these addbacks/adjustments will require careful scrutiny to determine whether the same should apply to the economic slowdown's effect on a particular borrower's business and the explicit drafting of the particular addback/adjustment. For example, much has already been written about the distinction between "losses" and "costs and expenses" and whether a reduction in revenues can properly be characterized as a "loss."

Financial Covenants

Many credit agreements provide for quarter-end financial covenant tests, with quarterly reporting due 45 days following fiscal quarter end; this will likely have numerous borrowers delivering compliance certificates showing non-compliance with financial covenants on or before May 15, 2020. Given recent shutdowns of businesses and lockdowns on a state-by-state basis, borrowers should not wait until the Q1 2020 reporting deadline to begin discussions with lenders to assess whether and on what terms covenant relief may be available.

Without proactive covenant relief, should the shutdowns of businesses and lockdowns continue much past March 2020, it seems reasonably foreseeable that a majority of borrowers will fail to comply with one or more financial covenants in Q2 2020.

Assignments

It is worth noting that some credit agreements may provide that a borrower loses its right to consent to any assignments, or that a "disqualified lender" list falls away, upon the occurrence of certain events of default, such as a financial covenant breach. This is a point that should be taken into consideration by lenders in connection with any offer of financial covenant relief. It will likely be important for many lenders to ensure outstanding paper remain as liquid as possible, and, therefore, available to the widest universe of potential buyers.

Discounted Buybacks

Many credit agreements include discounted voluntary buyback provisions pursuant to which a borrower or its parent can offer to buy outstanding loans below par. With the near certain fall in secondary market pricing for loans, it is expected that many borrowers, particularly sponsor-owned businesses, may look to take advantage of the discounted buyback provisions to reduce leverage. Most discounted buyback provisions include conditions such as no default or event of default and no outstanding revolving loans at the time of or after giving effect to the proposed purchase. This represents another point lenders should consider modifying in connection with any offer of financial covenant relief.

Prepayments of Junior Debt

Many credit agreements include some level of flexibility for borrowers to make prepayments of junior debt, whether from proceeds of a "builder basket" or otherwise. Again, any consideration of covenant relief should include an assessment as to whether the borrower should continue to enjoy this right going forward.

Excluded Collateral and Excluded Subsidiaries

While also negotiating potential covenant relief with borrowers, lenders may also wish to revisit "excluded collateral" definitions in order to use any leverage to obtain liens on collateral not previously perfected on – be it commercial tort claims, vehicle titles, previously deemed immaterial owned real property, bank accounts with nominal balances, or other categories of collateral formerly omitted from the collateral pool. Similarly, lenders may agree to grant covenant relief or waive COVID-19 triggered defaults in exchange for requiring certain categories of "excluded subsidiaries" to become loan parties, such as material foreign subsidiaries, unrestricted subsidiaries and immaterial subsidiaries. Negotiation leverage will be contingent upon the severity of the defaults and covenant relief proposal, whether the borrower is owned by an equity sponsor, EBITDA and industry of the company, among other factors.

Conclusion

The above list is by no means exclusive of the many issues and trends expected in middle market lending in light of COVID-19. Lenders should continue to be cautious in making any determination or judgment without first speaking to counsel. Please feel free to contact us for future guidance.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

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