
COVID-19: Credit Agreement Provisions to Consider in Light of the COVID-19 Outbreak

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Uncertainty over the scope and spread of the COVID-19 outbreak continues to negatively impact the domestic and worldwide economy. Disruptions to business as a result of stay-at-home or shelter-in-place orders, restrictions on travel, and other operational constraints and supply chain interruptions are the realities businesses are facing as a result of the pandemic. Many companies of various sizes and across a wide range of industries are drawing on their revolving credit facilities to increase their liquidity and add to their balance sheets to get them through these challenging times, including some that are drawing all available amounts under their credit lines. As companies develop strategies to deal with the economic impact of the COVID-19 outbreak, they should thoroughly understand the terms of their credit facilities, including material adverse effect clauses, financial covenants and borrowing base and reporting covenants.

1. Material Adverse Effect Clauses.

Most credit agreements have material adverse effect or material adverse change clauses (MAE Clauses) that will affect whether a borrower may borrow funds under a credit facility, and in some cases, may even trigger an event of default. As borrowers determine whether to borrow on their credit facilities, they should understand both the concept of the MAE Clause and the exact wording of the MAE Clause as it is used in their credit facility.

MAE Clauses are often heavily negotiated and usually have several independent prongs that are triggered upon the material deterioration of (i) the business or financial condition of the borrower, (ii) the ability of the borrower (and related loan parties) to perform obligations under the credit agreement or (iii) the value of collateral and/or the ability of the lender to foreclose on such collateral under the credit agreement.

The absence of an MAE is often a condition precedent to borrowing funds under a credit agreement or is woven into the package of representations and warranties that are “brought-down” by the borrower at the time of such borrowing. In addition, some credit agreements, particularly in connection with venture capital-backed companies, provide for an event of default if there is an MAE. Depending on how the MAE Clause is drafted, a lender may determine that the borrower’s business or financial condition has been materially and directly impacted by the COVID-19 outbreak

or that the overall economic uncertainty has created a material inability of the borrower to perform its obligations, including payment obligations, under the credit facility. Further, a lender may determine that the collateral or the ability of the lender to foreclose on the collateral has materially degraded because of disruptions in the borrower's supply chain.

Borrowers should reach out to business contacts prior to requesting unusual or large borrowings to explain their reasoning for the draw and gauge reactions. While a borrower cannot directly curtail the discretionary powers of the lender, it can leverage existing business relationships to establish a dialogue over the expected cash needs of the borrower and gather necessary information to prepare a strategy.

Historically, lenders have only invoked the MAE Clause as a barrier to borrowing sparingly. Lenders would prefer borrowers to be able to continue as a going concern, if at all possible. Lenders will also likely have concerns about lender liability and will want to prevent reputational damage in the market after conditions improve.

2. Certification Requirements.

If a borrower wishes to borrow under its credit facility, a responsible officer will have to certify that certain conditions under the credit facility have been met and the information being delivered to the lender is accurate. Usually those certifications include a representation that the MAE Clause has not been triggered. To dissuade a borrower from utilizing its available lines of credit, a lender may remind a borrower that the certifying officer is subject to personal civil and criminal liability with respect to such representations. That liability is generally triggered under the legal concept of fraud (e.g., the certifying officer knowingly or recklessly made a materially false statement with an intent to defraud the lender). As a result, prior to delivering certifications and reporting deliverables to its lender, the responsible officer of the borrower should understand and be comfortable with the accuracy of the information that is being provided.

3. Asset-Based Revolving Credit Lines.

If a borrower's credit facility includes an asset-based revolving line of credit, a borrower's borrowing base (an equation used to determine the amount available to be drawn) is usually determined by either the borrower's accounts receivable or its inventory (or some combination of the two). Accounts receivable and inventory available to be included in the borrower's borrowing base have to meet certain eligibility criteria as set forth in the credit agreement. As disruptions in the economy continue, a borrower may find accounts receivable becoming ineligible or its inventory reduced and, as a result, the amount of funds available under its line of revolving credit reduced along with other possible adverse consequences, such as automatic cash sweeps, weekly borrowing base certificate requirements or springing financial covenants. To the extent the borrower's credit facility has reserve requirements, a lender may also impose the reserves of the borrower against the line of credit as a result of a drop in the borrowing base. A borrower should thoroughly understand the eligibility criteria set forth in its credit agreement when strategizing when and how much it may need to draw on its line of credit.

4. Financial Covenants.

Borrowers should also thoroughly understand their financial covenants and plan accordingly. Failure to meet financial covenants may trigger an event of default or, at the very least, mean that a borrower may not borrow funds under its credit facility.

A borrower may be unable to meet its financial covenants because of an inability to meet revenue targets, to keep its debt-service ratio in compliance or to keep its leverage ratio in compliance. This may be as a result of reduced revenue, which in turn reduces the borrower's EBITDA.

A borrower should review its financial covenants and the component definitions, as well as its ability to stay in compliance with its financial covenants over the coming year. Financial covenants are usually measured on a monthly or quarterly basis, and compliance is determined when a borrower delivers its financial statements and other reporting deliverables. Although non-compliance generally triggers an immediate event of default, some credit agreements have equity cure provisions that give the borrower the ability to be brought back into compliance with the credit agreement. If a borrower has an equity cure right, they should consider if they intend to exercise this right and review the appropriate mechanics.

In addition to financial covenants, some credit facilities have liquidity covenants that require the borrower to maintain a certain amount of cash or cash equivalents on hand or in a designated account subject to the lender's control. Unlike financial covenants, liquidity covenants are not measured on a quarterly basis, but daily. Borrowers should be cognizant of any liquidity covenants as they manage their cash flow over the coming months.

A borrower should begin to strategize now for the coming fiscal quarters. If a borrower anticipates meeting its financial covenants for the current quarter but not the next quarter, now is a good time to understand the tools available to the borrower under its credit facilities to keep itself in compliance, and other strategies at its disposal. For example, a borrower should consider whether COVID-19 costs may be included as an extraordinary, non-recurring charge add-back under its definition of EBITDA. That way, the economic costs of COVID-19 may not reflect a drop in the EBITDA of the borrower and, as a result, its financial covenants may not be as severely impacted.

If the current financial covenants under the credit facility are no longer feasible, a borrower should prepare a revised covenant package amendment to discuss with their lender. As borrowers fail to meet their financial covenants and seek relief from their lenders, lenders may use this time as an opportunity to extract additional concessions from borrowers. A borrower will be in a better negotiating position if it understands its current situation, has a plan and can get ahead of any compliance issues early on, rather than waiting until it is in a distressed position to negotiate with its lender.

5. Borrower Reporting Requirements.

As more businesses are being disrupted with the impacts of the pandemic, borrowers should also review their reporting requirements under their credit facilities and ensure they will be able to deliver their financial statements within the time period required by their credit facilities. Consider whether it is prudent to request an amendment to your credit facility to allow additional time for monthly or

quarterly financial statements, or to deliver audited financial statements.

In addition to the reporting requirements under their credit facilities, borrowers that are SEC registrants should also consider their obligations under securities laws to disclose information deemed material to their investors with respect to their credit facilities and obligations thereunder, including determining whether a borrowing under their revolver needs to be disclosed on Form 8-K under Item 2.03 (Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant). In a recent press release, the SEC staff reminded public companies to consider their activities in light of their disclosure obligations under federal securities laws, and further reminded companies that when they do disclose material information related to the impacts of the COVID-19 outbreak, they should take the necessary steps to avoid selective disclosures and to disseminate such information broadly.

6. Final Thoughts.

Borrowers are not the only entities considering the long-term effects the COVID-19 outbreak will have on business and financial operations. As lenders face pressure from borrowers to advance funds under their credit facilities, lenders may start closely scrutinizing MAE Clauses, financial covenants, and the eligibility criteria under borrowing bases when determining if and how much is available to a borrower under its credit facility. Further, lenders may wish to conduct collateral reviews of the borrower prior to advancing under such credit facilities.

In anticipation of this, borrowers should evaluate their credit agreements, the obligations thereunder and options available to them in the event of difficulties meeting those obligations. Borrowers should also be proactive in managing their business relationships with their lenders, including strategizing now for various scenarios, so they are in a good position to manage the uncertainty ahead.

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