CARRUTHERS & ROTH, P.A.
ATTORNEYS AT LAW

CLIENT ALERT

March 31, 2020

Review Your Credit Facilities in the Midst of the COVID-19 Pandemic

By Britton C. Lewis

Borrowers and lenders alike may feel inclined to review loan documents only on two occasions: at closing and upon the occurrence of an event of default. In today's unprecedented times, there is a third very essential time to review documents relating to your credit or debt facilities: **right now**.

In addition to payment defaults, loan facilities are packed full of covenants, conditions, representations, and warranties which, when business is good, may not warrant much consideration. But in a time where business stoppages, repurposing of equipment, financial strain, and social distancing are the new normal, any assumptions made by a borrower or a lender while sitting at the closing table cannot be relied upon.

This client alert identifies some key provisions in loan facilities that should be reviewed, and potentially addressed, for both borrowers and lenders. This list is not, and cannot be, all-encompassing, as circumstances differ tremendously from one loan facility to the next. A complete and detailed review of your documentation is strongly encouraged.

No Material Adverse Effect. Lenders almost unanimously seek either a negative covenant or a representation and warranty that a borrower will not suffer a material adverse change in such borrower's financial condition or business operations during the life of the loan. Some loan documents even make a material adverse effect an event of default. COVID-19 and the corresponding governmental responses present numerous threats to materially and adversely impact the financial condition or business operations of businesses across many industries. Borrowers and lenders should work collaboratively on developing plans to mitigate the impacts of such changes.

Continuous Operations. Many loan facilities include covenants to maintain continuous operations. The exact meaning of that provision depends on the language of the loan documents, but stay-home orders and corresponding work-from-home policies paired with modified customer access may interfere with and actually prevent a borrower's ability to comply with such covenants.

No New Business. Loan facilities may also restrict borrowers from engaging in new or different business. The motivation behind such provision is for the purpose of preventing borrowers from leveraging loan proceeds to engage in risky enterprises not previously contemplated in the loan documents. However, in today's environment where distillers are producing hand sanitizer and manufacturers across industries are being called to assist in the production of personal protective equipment and other medical supplies, opportunities for temporary new business abound. Borrowers and lenders should discuss such opportunities quickly before borrowers ramp up to participate in new business.

New Loans. The Federal Government has responded to the COVID-19 crisis with offers of numerous kinds of loans, both short term and long term. But, it is not uncommon for a loan facility to prohibit any kind of new debt for borrowed money. Borrowers that take advantage of these new government subsidized loans need to review their loan documents to determine if waivers from lenders are necessary.

Financial Covenants. The decrease in cash flow almost overnight presents an unusual set of circumstances for many borrowers that may find themselves in precarious positions relating to financial covenants that are contained in most loan facilities. With declining revenues, it is probable that many borrowers will fail to comply with debt service coverage ratios, minimum EBITDA covenants, or net worth covenants. Projections need to be prepared earlier than later and waivers or forbearances need to be addressed.

Continued Borrowings. Many revolving lines of credit are asset based, meaning that borrowings are based upon a borrowing base of receivables or inventory or both. As many borrowers are ordered to shut down as being non-essential, it is probable that borrowing bases will shrink, as new receivables are not being created and existing inventory levels are not being maintained. Borrowers need to begin preparing availability projections and discussing with their lenders needs for overadvances or other temporary measures to avoid a liquidity crisis.

Compliance with Governmental Orders. For numerous reasons, lenders require borrowers to comply with applicable laws and governmental orders. Compliance with orders to close business or transition to work-from-home for non-essential businesses are not excepted from such provisions. Borrowers in certain circumstances thus face an unavoidable event of default—comply with governmental orders but cease continuous operation; or continue to operate but fail to comply with governmental orders.

Third Party Defaults. Many loan facilities incorporate third party default provisions from other agreements, that essentially provide that a default under some other agreement will also be a default under the loan agreement. Borrowers and lenders need to be aware of the potential for defaulting under a lease (i.e. for failure to continuously operate) or for defaulting on obligations to trade creditors that in turn would cause a default under the loan agreement.

Trade Relations/Essential Customers or Essential Vendors. Along the same lines as the "No Material Adverse Effect" provisions, lenders frequently require borrowers to covenant that its core business will continue uninterrupted. For borrowers that cater their business to a single customer, or rely heavily on a certain vendor, the pandemic may present challenges as businesses key to the borrower's operations shut their doors - either temporarily or for good. Borrowers and lenders need to identify which businesses are key to the business and actively engage in discussions about how to mitigate impacts of third-party closures.

Renewals of Representations and Warranties. Most loan facilities that involve multiple draws or borrowings under a revolving line of credit provide that, as a condition of each draw or borrowing, the borrower's representations and warranties must be true and correct in all material respects at the time of the lender's making any requested draw and borrower. Because of the changed circumstances created by the COVID-19 crisis, many of those representations and warranties will no longer be true and may excuse the lender from making the requested draw or revolving loan. Prior to requesting any new draws or borrowings, borrowers should carefully review the existing representations and warranties, identify how circumstances may have changed and, if necessary, request waivers or modifications from their lenders.

<u>Construction Loans</u>. Construction loans present additional challenges for borrowers and lenders. In addition to the other matters mentioned in this alert, considerations need to be given to how construction timelines may change, how budgets will need to be modified, and whether change orders are necessary. Careful review of when consents or modifications are needed and how and when they should be requested and granted will be necessary for lenders and borrowers that are parties to construction loans.

<u>Waiver of Default</u>. In a time of unprecedented short-term uncertainty, lenders may feel particularly inclined to waive defaults in the short-term. Many loan facilities will include a provision that a waiver of default on one occasion is not a waiver of future defaults. Lenders should make sure to clarify that as they work with their borrowers, borrowers should avoid relying on repeated waivers of default.

<u>Conclusion</u>. The impact of the COVID-19 pandemic on commercial loans are numerous and complex. Circumstances are constantly and quickly evolving. Both borrowers and lenders should carefully review all documentation related to existing loan facilities. If questions regarding how the pandemic and changing business climate remain, now is the time to reach out to the other side and to counsel.

Carruthers & Roth is here to help if you have questions or concerns on the impact of the COVID-19 pandemic on your loan facilities, and what steps are needed to work through potential events of default. Please feel free to contact any member of our <u>Banking and Finance</u> and <u>Real Estate</u> Teams with questions related to this client alert.