

### **Are your loan documents up to the test in the wake of COVID-19?**

As the COVID-19 pandemic spreads across our nation, a growing number of businesses from many different sectors have started to notify markets about the adverse impact that COVID-19 will have on their financial condition. It is likely that a significant number of businesses will generate lower earnings in the near term due to supply chain disruptions and reduced consumer demand as more States (and countries) implement strategies to contain the spread of the virus. As a result, borrowers will have greater difficulty in complying with any covenants in their loan documents and, in certain instances, servicing their debt.

Lenders will need to examine their loan documents closely to review, among other things, any financial covenants, reporting requirements, definitions of financial terms, and potential penalties for breaches of representations and warranties. While the COVID-19 pandemic is new, prior financial crises provide some insight into the considerations and financial impact that lenders and borrowers may deal with in the months to come. Below are a few key provisions in loan documents that will likely be of focus as the effects of COVID-19 ripple through middle-market lending.

#### **Financial Covenants and Reporting Requirements**

A breach of a covenant generally allows a lender to declare a default under the loan documents and to demand early repayment or act as a draw-stop to revolving facilities so that a lender's exposure can be limited. Many borrowers facing a prospective breach are likely considering whether they can or should draw on existing availability for future liquidity needs. As a result, lenders should pay close attention as to whether the conditions to borrowing have been satisfied.

Lenders will need to assess the impact of COVID-19 on a borrower's ability to comply with its financial covenants. When testing financial covenants, many loan agreements measure EBITDA over the last four fiscal quarters, and the negative impact of the virus could last well into 2021. Lenders should scrutinize financial covenants and related definitions (for example "consolidated EBITDA" and similar terms) in loan documents carefully to determine if any add-backs (such as for cost savings) or equity cure provisions may be utilized to limit the amount of a particular covenant's impact resulting from a decrease in net income or EBITDA. Also, modifications to the definition of "consolidated EBITDA" may have implications beyond financial covenant compliance such as mandatory prepayment provisions, certain covenant baskets (such as additional debt and permitted investments), and possibly pricing.

Lenders need to be cognizant of reporting and notification obligations. While reporting requirements vary between loan agreements, they normally include: (i) compliance certificates, (ii)

financial information and auditors reports, and (iii) reporting matters relating to litigation, material contracts, and/or developments expected to have a material adverse effect.

### **Representations and Warranties**

In the context of COVID-19, a number of the customary representations and warranties in loan documents should be given extra consideration:

- **Material Adverse Effect:** It is common for loan agreements to contain a representation and warranty that as of the date of closing the loan, there have been no (or are not expected to be) circumstances having a material adverse effect on the assets, business or financial condition of the borrower since a specified prior date (often the most recent financial statement). In addition, Borrowers are typically required to certify to their lenders that the representations and warranties in the loan documents remain true and correct as a condition to each borrowing. Bringing down the “material adverse effect” representation may be problematic for a borrower with a temporary, but material dip in performance and could result in a breach despite the fact that it is not yet in violation of any financial covenants.
- **No Default:** This representation typically pertains to defaults under the loan documents and may include defaults or termination events under other material agreements. This representation could be relevant where a company’s performance under third party contracts is materially adversely affected by COVID-19.
- **Litigation:** Depending on the particular borrower, the representations relating to litigation and judgments may need to be reviewed. Careful review should be made for businesses that may be subject to disputes as a result of the failure to perform under material contracts (for example, litigation relating to the assertion that COVID-19 constitutes a force majeure event under the relevant contract).

There may also be other deal-specific representations that need to be reviewed. Lenders should be aware of the timing for when borrowers are required to make representations, such as when delivering any certificates or borrowing requests, or whether any such representations are continuing, in order to determine whether the borrower is in compliance at the relevant times.

### **Events of Default**

Beyond the typical circumstances that constitute an event of default, in the context of COVID-19, the following provisions should be given careful review and may trigger an event of default under the loan documents:

- **Material Adverse Effect/Material Adverse Change (“MAC”):** Establishing a MAC is a fact and clause specific determination that should be made on case-by-case basis. Some considerations when weighing if a MAC event exists include the intentions and prior knowledge of the parties, the wording of the MAC clause, the surrounding terms of any contract in question, and market standards. A steep decline in a company’s year on year performance (and in a more limited context, an even shorter-term) could constitute a MAC. However, case law tells us that the materiality should be based on a substantial threat to the overall earnings potential of the business in a durationally significant manner. In general, courts will apply a fact specific analysis and short-term events or adverse economic conditions having a temporary adverse effect on a borrower may not constitute a MAC. In addition, lenders must also be cognizant of any potential liability to a borrower if

they improperly invoke this provision. Accordingly, lenders should seek advice from their counsel to assist them in analyzing the particular facts and circumstances of the business and the specific language contained in the applicable loan documents.

- **Audit Reports:** Under certain loan agreements, auditors must qualify their report with a “going concern” qualification and not being able to do so may result in an event of default. Typically, a “going concern” qualification would result from an auditor’s view that the company will not be able to satisfy all of its short-term (i.e., one year or less) obligations, including the potential acceleration of indebtedness and maturities of indebtedness, without a likelihood of refinancing.
- **Insolvency:** Lenders should carefully review the applicable provisions for the “bankruptcy event of default” as there may be circumstances other than an actual bankruptcy proceeding that could cause an event of default. For example, certain loan agreements provide that if the borrower admits its inability to pay its debts, such event would constitute an event of default. Another example is that a borrower’s out-of-court negotiations with its creditors to restructure its debt may be included in the “bankruptcy event of default” provision.

If you are negotiating your next deal or working with an existing relationship and have any questions or concerns about how COVID-19 may have an impact, please contact one of our Bodman attorneys Noel Ravenscroft at (313) 392-1067 or [nravesncroft@bodmanlaw.com](mailto:nravesncroft@bodmanlaw.com), Brian Kersey at (616) 205-3129 or [bkersey@bodmanlaw.com](mailto:bkersey@bodmanlaw.com) or Adam Weiner (313) 392-1076 or [aweiner@bodmanlaw.com](mailto:aweiner@bodmanlaw.com) who can help you navigate these issues. Bodman cannot respond to your questions or receive information from you without first clearing potential conflicts with other clients. Thank you for your patience and understanding.