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PERSPECTIVE

Exceptions in credit agreements addressing COVID-19 crisis

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The novel coronavirus has resulted in a seismic shift in the way businesses are run and the way we live on a day-to-day basis. It is still early in the post-COVID-19 credit cycle, but the pandemic is already working its way into credit documents, and may likely become a fixture in them going forward. This article analyzes certain material provisions tested by COVID-19 and other COVID-19-specific provisions which are starting to appear in loan agreements, and how private credit lenders are likely to address them.

PART I OF II

COVID-19 Exception in MAE Clauses

The outbreak of COVID-19 has placed material adverse effect (MAE) and material adverse change (MAC) clauses (used interchangeably in this article) in the spotlight. As revenues for many businesses sharply declined, borrowers have explored their range of liquidity options, including drawing on revolving credit facilities or delayed draw facilities available under credit agreements with their existing lenders. This has caused lenders to take a closer look at the conditions under which they are obligated to fund such borrowings.

In most credit agreements, one of the conditions to funding a revolving or delayed draw loan is a bring-down of the representations and warranties, which must be "true and correct in all material respects" as of the date of the borrowing (or as of an earlier date to the extent they expressly relate to an earlier date). A common representation is the MAE clause, which generally requires the borrower to represent and warrant that since a specified date there has been no event or circumstance, either individually or in the aggregate, that has had or could reasonably be expected to have a material adverse effect. In the financing context, "material adverse effect" is typically defined as a circumstance or condition that would or could reasonably be expected to materially and adversely affect (1) the business, financial condition or operations of the borrower and its subsidiaries, (2) the ability of the borrower and the other loan parties to perform their payment obligations (or sometimes their ability to perform all obligations) under the loan documents, or (3) the rights and remedies of the agent and the lenders under the loan documents, in each case, taken as a whole.

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Most of the existing case law on what constitutes an MAE is in the acquisition context and is highly fact-specific. In that context, the effects on the business must usually have been "durationally significant" and lasting over a period of years. In certain cases, courts have analyzed the severity of an impact based on whether the parties to the agreement contemplated such an event at the time the agreement was entered into, whether either party had any control over the event, and the overall extent of the impact on the company's business and operations. The test is not black and white, and has historically been a difficult one for purchasers to satisfy in the acquisition context.

Both the language of MAE provisions typically included in merger and acquisition agreements and the risks allocated in those agreements usually differ materially from those in credit agreements. And, there is scant case law in the financing context from which to draw for guidance, though the fact specific, case by case analysis doubtless will apply.

In an effort to eliminate any possibility of allowing lenders in new transactions to claim that the COVID-19 outbreak has resulted in an MAE, borrowers are requesting to include the effects of COVID-19 as an exception to the MAE definition. The result of carving COVID-19 out of the MAE definition would be that for companies that have been impacted by COVID-19, it will be easier for the borrower to make the MAE representation, and conversely, more difficult for lenders to make the argument that an MAE has occurred and thus they are not obligated to fund. Explicitly carving out the effects of COVID-19 would undercut lender protections, raising the already fairly high bar of establishing an MAE arising from the effects of COVID-19 to a level that might not afford lenders adequate protections.

Furthermore, as the effects of the COVID-19 outbreak continue to become more widespread, it would not be surprising for borrowers to seek exceptions to the MAE to include more generic references to epidemics and other natural disasters, which exceptions, although seen in the acquisition context, are generally not common in financing MAE definitions. As such, a move towards carving out COVID-19 or other pandemics could potentially result in an ever-expanding list of exceptions to the financing MAE definition in certain circumstances, with perhaps a trend toward making it more similar to the acquisition MAE definition.

From a risk allocation perspective, a blanket COVID-19 carveout to the MAE definition seems to yield the wrong result for lenders. In an acquisition context, there are often carveouts in an MAE definition for general market downturns or changes in general economic conditions. Similar to how carveouts in an acquisition context reallocate risk from the seller to the buyer, a COVID-19 carveout in a financing context reallocates risk from the borrower to the lender. This is contrary to the standard allocation of risk in a lending transaction in which the borrower typically bears the risk associated with factors that affect their ability to repay the loan. Therefore, absent a narrowing of the carve out for specific purposes and/or appropriate concessions from the borrower, lenders will likely continue to push back on requests to include a COVID-19 carveout to the MAE definition in credit agreements and related amendments.

COVID-19 Exception and Going Concern Qualifications in Year-End Audits

The impact of COVID-19 is not just a theoretical question of what qualifies as an MAE or MAC. It can have immediate consequences for the company's ability to satisfy its financial reporting obligations to the lender, and it is something that accounting firms must work quickly to address.

Credit agreements require that the borrower provide, within a time period typically ranging from 120 to 150 days after the end of its fiscal year, a consolidated balance sheet of the loan parties and their subsidiaries, as well as a consolidated statement of operations, shareholders' equity and cash flows for such fiscal year. These deliverables will usually include comparisons to the figures for the previous fiscal year, as well as a comparison against the figures set forth for the applicable year in the annual operating and capital expenditure budgets and cash flow forecasts provided to the lenders. These annual financial statements have to be certified by a pre-approved accounting firm, or by another independent public accountant of national or regional standing.

The accounting firm's certification cannot be subject to any "going concern" qualification or exception or any other qualification or exception as to the scope of the firm's audit. This "going concern" principle is based on the assumption that the business will continue in the future, unless there is evidence to the contrary. FASB ASC 205-40 requires that the company's management evaluate its ability to continue as a "going concern" within one year after the date the financials are issued. As such, the ability of the company to continue as a "going concern" is called into question if there are circumstances that, in the aggregate, make it probable that the company will not be able to meet its liabilities as they become due during that one-year period.

In recent years, it has become increasingly common for there to be exceptions to the general prohibition on such qualifications and exceptions. These include carve-outs for the prospective inability to meet a financial covenant and the impending maturity of any indebtedness of the company. Certain private equity sponsors have requested that such exceptions be expanded to include events or occurrences directly (or indirectly) arising out of, or attributable to, COVID-19, including downturns in the financial markets. There are many factors that impact any "going concern" assessment — geography, industry, customer and supplier bases, and financing sources of the entity. But COVID-19's long-term effects are still unknown, particularly since markets are still choppy, and there is daily uncertainty around the length and extent of "stay at home" orders that could keep customers out of businesses for months to come. So a request for relief from the "going concern" qualification today inherently requires that lenders and borrowers rely on accounting firms to eventually determine how GAAP will treat this unique situation. In some instances, auditors may need to consider recent developments in the company's financial health, or take into account the detail and feasibility of management's future plans to recover from (or at least buffer against) COVID-19's most dire predicted consequences. In the event that a private equity sponsor thinks that an auditor will need to include a "going concern" qualification related to COVID-19's impact, the question is, can a lender push back on the request? Likely no. If an auditor is aware of risks to the company's liquidity or access to capital and cannot issue a "going concern" opinion, lenders will likely need to consider whether enhanced reporting is required, or if more communication with the company is needed on a regular basis, in order to ensure that notwithstanding the auditor's opinion, management is taking steps to shore up the company's long-term health. As a result, until COVID-19's effects are fully known, lenders may need to accommodate requests to include COVID-19-related carveouts to "going concern" opinions. However, a possibly more likely scenario is that lenders wait to make any changes to their reporting requirements until there is uniform treatment of the pandemic and its impact by accounting firms — this way, lenders will be able to allow for discrete exceptions, rather than broad (and possibly premature) exclusions. ■

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