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PERSPECTIVE

Exceptions in credit agreements addressing COVID-19 crisis

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This article discusses additional considerations related to COVID-19's impact on credit agreements.

PART II OF II

Exclusion of COVID-19's Impacts From EBITDA Addbacks

The calculation of EBITDA plays a major role in many financing arrangements, including the determination of, and compliance with, financial covenants. EBITDA can also serve as a basis for providing flexibility to the company for incurring more debt, more liens, or making more restricted payments, among others. Now, certain "addbacks" to EBITDA are more likely than others to come under scrutiny to determine how COVID-19's impacts will trickle through a Credit Agreement's restrictions and flexibilities.

Non-Recurring Items

In recent years, EBITDA addbacks have become increasingly broad, with any caps (dollar or percentage) falling away as the size of the borrower increases. Addbacks for "extraordinary" or "non-recurring" items are one such example — they are usually undefined, and usually uncapped. COVID-19 has called into question what constitutes an "extraordinary" or "non-recurring" item. For example, lenders will need to grapple with whether costs spent on virtual training, or the development of data privacy policies, or digital employee handbooks to ease the transition to working remotely, should all qualify as a "onetime" cost that falls into the broad "non-recurring" addback. While lenders are still adjusting and assessing the requests for additional flexibility by borrowers, some have decided that at least some portion of COVID-19-related costs and expenses could constitute "non-recurring" items. This ranges from the costs to buy personal protective equipment for employees outside the ordinary course of business, to expenditures on penalties paid to customers arising from projects which are delayed or canceled due to COVID-19. Conversely, the market is generally settled on the fact that this addback would not include lost earnings or income, as those would not constitute a loss, charge or expense to which the addback is usually limited.

As a result, some private equity sponsors are trying to create entirely new addbacks to address COVID-19, rather than relying on potential flexibility in existing ones. An example is the request to add back "lost earnings" due to "non-recurring events." As noted above, lost earnings do not fall into the classic "non-recurring item" addback. However, if this addback is introduced into the calculation, and if COVID-19 qualifies as a non-recurring event, then a borrower could add earnings lost due to COVID-19 or any other arguably non-recurring event unless otherwise specified. Although this addback is generally included as a result of the effects of COVID-19, the provision itself is not limited to COVID-19. It may open the door to including the possible loss of revenue from any other non-recurring event. As a result, to the extent that such an addback is introduced, lenders would likely want to specify what constitutes a non-recurring event, and also how "lost revenues" are going to be calculated and supported by the company.

Business Interruption Insurance Proceeds

Business interruption insurance proceeds have also become an increasingly common addback to EBITDA. These are proceeds from policies which cover losses of income due to slowdowns or suspensions of a company's activities, and are usually triggered when the company suffers a physical loss or damage to insured property. In some cases, borrowers may push to include any proceeds received as a result of COVID-19 in their EBITDA calculations. However, these policies vary — some may cover pandemics, communicable diseases, both or neither. Some may also cover operational suspensions arising from a governmental decree, such as a "stay at home" order, but it is unclear how common that is. In fact, insurance carriers will likely dispute that a true "physical loss" has occurred just because a factory has shut down due to government guidance. And if history is any guide, after the

SARS outbreak in the early 21st century, many insurers added exclusions to business interruption policies to prohibit coverage for losses related to viral outbreaks. The fact that there has been congressional pressure for insurance organizations to cover COVID-19-related losses will ensure that there will be conflict about what is covered.

It is important to note that business interruption insurance proceeds are included in net income only if they have been received by the company and any prospective proceeds have been affirmatively confirmed by the insurer. If the proceeds have not been received yet, then there must be a “reasonable expectation” or “good faith belief” that a payout will in fact occur, which may be unlikely given the typical limitations in place in the policies discussed above. As a result, lenders will need to examine policies on a case-by-case basis to determine whether any COVID-19-related payout is even possible and how such proceeds will be captured in the EBITDA calculation.

Non-recurring items and business interruption proceeds are examples of how (and why) COVID-19 will need to be explicitly addressed in EBITDA calculations going forward, to ensure that lenders and borrowers are in agreement about what can and cannot be included. Until the extent of the virus’s impact on the economy and the labor force is fully understood, lenders will likely only be willing to include limited and bespoke flexibility, if any. Until then, as certain segments of the financing market have provided for very generous addbacks to EBITDA, lenders should remain vigilant of what is actually included as an addback.

Conclusion

While existing provisions are being tested against the effects of COVID-19 and other specific COVID-19-related provisions are being introduced into Credit Agreements, uncertainty surrounding the full extent of the pandemic’s impact will likely result in lenders taking a tailored approach to allowing additional flexibility in their documents, as well as closely scrutinizing a borrower’s ability to leverage existing provisions in its favor. The “Material Adverse Effect” definition, audit qualification, and EBITDA calculations are the most common provisions to address COVID-19 right now, but it is possible that the list could expand in the months to come as the pandemic’s true effects become more clear. ■

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