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INSIGHT: Covid-19 Credit Concessions Rely on Give-and-Take

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Lenders have been willing to make certain concessions on loans in an out-of-court context due to pandemic-related distress, Morgan, Lewis & Bockius LLP attorneys say. The loan market has seen its fair share of amendment and restructuring activity, and there's every reason to believe the pace of this activity will continue and even increase this year.

The Covid-19 pandemic has contributed to a wave of debt restructurings, waivers, and amendments as borrowers grapple with the challenges of constraints on their liquidity and inability to satisfy covenants and obligations arising under their loan documents.

To date, lenders have largely been willing to proceed in a constructive manner in evaluating these difficult situations by recognizing the (hopefully) temporal nature of the distress and not acting precipitously by accelerating obligations or enforcing significant remedies.

Most lenders expect to see support from existing stakeholders in exchange for relief on financial maintenance covenants or other operating covenants. Borrowers and their equity owners seek to minimize the scope of additional credit support or capital contributed and to maximize their flexibility to continue to operate without overly onerous covenants that may limit optionality during these unprecedented and unpredictable times.

In this exchange for additional credit support, capital contributed, and/or additional covenants, lenders have been willing to make various concessions.

Trends in Concessions

Some lenders have agreed to a limited amount of principal or interest payment deferral for a defined period to enable the borrower to continue to meet its operating obligations.

Other lenders have reduced the near-term amounts due on the debt in exchange for increased payment increments as time progresses. Lenders realize that many businesses may come back strong from a near-term liquidity crunch, particularly if a borrower is in a "non-essential" line of business as defined by various state governments.

Exit fees or enhanced or expanded prepayment premiums implemented in exchange for near-term interest payment deferrals have also been granted.

Another lender concession has been to provide for a "holiday" on testing financial covenants. The duration of the holiday would somewhat depend on the nature of the business and how likely it is that normal operations would resume.

For example, a chain of gyms might find that lenders are more prone to agree to a longer deferral, given that the runway to achieve pre–Covid-19 levels of subscribership activity is anticipated to be long.

Lenders also have been willing to modify the financial covenants by either loosening the actual required financial covenant levels or revising the terms of the core definitions, including adjusted EBITDA (adjusted normalized earnings) to account for adjustments that may be relevant to the Covid-19 pandemic's effects.

Many borrowers have been pursuing specific EBITDA add-backs for losses or expenses arising from Covid-19. While not all lenders are amenable to this approach, many have been. Lenders recognize that it is not beneficial to continue to test traditional financial covenants for nonperforming businesses and pursue remedies when the covenants are not met.

In lieu of leverage ratios and fixed charge coverage ratios, which are all premised on a comparison of adjusted EBITDA to other debt on the business, some lenders have instead been requiring a minimum liquidity covenant until regular financial covenant testing recommences, so there is some ability to monitor the borrower's utilization of the cash that it does have.

Flexibility in Audited Financials

Finally, as a related matter many borrowers have run into difficulty in producing audited financial statements for fiscal year 2020, as many auditors are including Covid-19–related qualifications or explanatory notes. Lenders have been largely flexible on the delivery date and in permitting such qualifying or explanatory language in audited financials.

Borrowers also have been successful in lobbying their lenders to permit asset dispositions, exclusive intellectual property licenses or transfers, and other non–ordinary course liquidity-generating events. A pay-down of some part of the debt may be required in connection with a consent to allow such transactions to proceed, though this is not always required if retaining the cash as working capital for the business would be more beneficial.

Lenders Expect Some Concessions

On the other side, lenders expect concessions as well. One of the most notable has been to require that equity owners provide some degree of credit support, including direct additional liquidity. This credit support can take numerous forms, including equity owner guarantees, posted letters of credit to the benefit of the borrower or the incumbent lender, and equity commitments from the owners.

In exchange for financial covenant relief or deferral of certain payments, lenders may temporarily shut off revolving credit lines or terminate delayed draw loan commitments. These modifications reflect the reality that lenders are often loath to fund additional liquidity into already contracted businesses.

The topic of whether a "material adverse effect" as defined in loan documents has occurred is often a matter for debate but has served as a possible hook for lenders to rely on to accomplish the goal of curtailing future funding to borrowers.

Another phenomenon in certain credits has been an increased focus on creative liquidity opportunities in which certain lenders may take advantage of "market technology," including incremental facilities and non–pro rata debt purchase provisions, to provide favorable debt terms to existing borrowers to the detriment of the collateral or payment priority of other existing lenders in the same credit facility.

It remains to be seen whether recent trends in rational activity on both sides of these negotiations will continue or if "zero sum" approaches will become more common, resulting in more bankruptcy cases and out-of-court reorganizations for more borrowers.

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