Proskauer

Coronavirus: Private Credit Lenders

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The unexpected emergence of the COVID-19 virus presents a wide range of new challenges and opportunities. The initial reaction of the syndicated market has been to pull back. In these times, private credit lenders act as ready sources of capital and liquidity in creative structures. At the same time, prudent private credit lenders are stress testing their existing portfolio. As private credit lenders consider the opportunities and risks that COVID-19 presents on new and existing portfolio financings, we wanted to highlight a few unique considerations.

Leveraged Acquisition Financings: The current COVID-19 environment could present opportunities for private credit lenders to step in while the syndicated market has stepped back. However, COVID-19 might impact the documentation of leveraged buy-out transactions in a number of ways. For example:

- *Acquisition Agreements & Lender Commitments*. Generally, sponsor-backed acquisitions are subject to "certain funds" financing commitments subject only to a limited list of narrow conditions to closing. The limited representations and warranties, the truth and accuracy of which are conditions to closing, generally include "acquisition agreement representations"; that is, the representations and warranties made in the acquisition agreement which, if not satisfied, would give the sponsor/buyer the ability to terminate the acquisition agreement (and concomitantly, the lender the ability by extension to terminate the financing commitment). These acquisition representations are often qualified by no "Material Adverse Effect" provisions. Additionally, there being no "Material Adverse Effect" since a referenced financial date is a condition to close – but only to the extent that the occurrence of such Material Adverse Effect gives the buyer the ability to terminate the transaction. "Material Adverse Effect" is generally defined by reference to that term (the "***MAE Clause***") as defined in the acquisition agreement.

In new acquisition financing transactions, private credit lenders should anticipate that there may be action between buyers and sellers in the negotiation of MAE Clauses in the attempt address the impact of COVID-19. Private credit lenders should keep an eye out for the possibility of special COVID-19 exceptions (or, more broadly, exceptions for any epidemic, pandemic or disease outbreaks) in addition to the customary exceptions for acts of God as these will both limit the ability of the sponsor to terminate the transaction and the lender's ability to terminate its commitment.

- *Transaction Timeline*. Some transactions require government approvals such as HSA or other domestic or foreign government approvals. Given the general stress on government agencies and potential for illness or precautionary quarantine of personnel or even a general shutdown of government agencies in various jurisdictions, private credit lenders should anticipate that the approval process could be significantly delayed. As a result, sponsors may look for extended commitment periods to anticipate this contingency, particularly if the transaction requires regulatory approval in foreign jurisdictions.
- *Due Diligence*. Naturally, in these uncertain times, private credit lenders are taking extra precautions to dig deeper into diligence issues, which may require additional terms or protections to be addressed in documentation. Areas of particularly inquiry include:
    - *Financials & Projections*. Stress testing financials and projections for a sustained COVID-19 event, including stress testing cash flow projections and ability of the company to manage through multiple quarters of disruption.
    - *Supply Chains*. Stress testing supply chains, including for slowdowns or shutdowns, transportation restrictions and import delays or restrictions.
    - *Material Contracts*. Analysis of obligations under contracts, risk of inability to perform, cure and termination provisions and damage/litigation risks.
    - *Employment & Key Persons*. Analysis of the potential need to rationalize a workforce, union issues, employment contracts and key persons and related employment concerns should the company need the flexibility to adjust its workforce.

EBITDA & Financial Covenants. A key aspect of all leverage loan transactions is the definition of EBITDA and its related component definitions, the existence or absence of financial covenants, and provisions related to those covenants. Whether or not the financing is subject to financial covenants, EBITDA definitions impact other key covenants such as debt, liens, investments and restricted payments. Lenders should refresh on EBITDA definitions given that the documentation trend has been to liberalize add-backs and increase or eliminate caps entirely. Among add-backs lenders should consider include:

- Add-backs for extraordinary, non-recurring, exceptional and unusual losses, charges and expenses. These terms are not defined and are generally uncapped. While they are typically viewed as relating to one-time events, the scope of these add-backs could be tested in connection with add-backs justified on the basis of the impact of COVID-19.
    - In addition, there are common business responses to COVID-19 that borrowers will assert fall within the bounds of such add-backs. For example, the cost of upgrading IT infrastructure, holding remote training sessions, designing and instituting employee policies, and implementing other similar initiatives designed to allow employees to work remotely during the contagion.
- Restructuring charges, including severance, consolidation, and other charges incurred in order to address COVID-19 related changes in the business.
- The amount of management, monitoring, consulting and advisory fees under the sponsor management agreement which, if not capped, may increase on the basis of activity to address COVID-19 challenges.

Borrowers may also choose to avail themselves of the flexibility to manage the timing of add-backs unrelated to COVID-19 in order to counteract a decline in CNI or EBITDA due to COVID-19. For example, a business that has a planned initiative to consolidate two locations in the medium- to long-term may choose to bring forward that consolidation into the near-term in order to benefit from the run-rate cost savings associated with the consolidation.

In any event, private credit lenders should anticipate that borrowers will look to use the flexibility prevalent in many credit agreements to add-back initiatives (and the timing of the taking of these initiatives) to maximize add-backs. Lenders should scrutinize financial covenants and leverage ratios to ensure these add-backs are factual and supportable, understand the pro forma impact and verify that they are not masking larger problems.

For those credit agreements with financial covenants, private credit lenders should anticipate borrowers (particularly in directly affected industries such as travel, transportation, entertainment, and energy) may request flexibility or, in some cases, covenant holidays. We have seen in some European deals requests for a mechanism inserted in financial covenants which basically allows the borrower to look back and use a prior period EBITDA if there is a systematic shock to the relevant industry due to COVID-19.

Bringdown of Representations & Warranties. While representations and warranties in a "certain funds" transaction are limited at closing, there may be instances in which the company is required to bring down its representations and warranties. For instance, they may be required to bring down representations and warranties in connection with accessing revolving lines of credit, incremental financing or delayed draw loans. Borrowers may be challenged to bring down solvency, material contracts, no proceedings or similar representations.

General Monitoring. Undoubtedly during times like this borrowers (and sponsors) and private credit lenders are actively communicating to understand the current and future impact of COVID-19. Nonetheless, lender should keep in mind that credit agreements generally contain reporting obligations regarding matters relating to litigation, judgments, and sometimes material contracts, as well as a covenant that requires the borrower to provide such information as the lender may reasonably request relating to the borrower or its operations and afford the lender the ability to conduct inspections. Lenders should consider using these information rights if a borrower is not reasonably forthcoming with information.

Refinancing, Debt Buybacks, and Dutch Auctions. The disruption in the syndicated market caused by the effects of COVID-19 and reaction of the Federal Reserve by reducing the interest rate (perhaps one of a series of reductions) may also present opportunities for borrowers to refinance their existing debt at lower rates or buy back debt at below par. Private credit lenders should refresh on the refinancing and debt buyback provisions, including debt affiliate restrictions. Private credit lenders may be sources of liquidity to facilitate these refinancings or debt buybacks.

Business Interruption Insurance. Private credit lenders may want to refresh on the adequacy and scope of borrower's insurance, including whether the borrower has business interruption insurance and whether it covers pandemics or communicable diseases such as COVID-19.

Defaults, Cures, Amendments and Waivers. The economic impact of COVID-19 is rapidly changing daily. Best practices includes increased communication between borrowers, sponsors and private credit lenders, general industry monitoring and stress testing portfolio loans to anticipate issues, including the impact on revenue and the adequacy of liquidity to ride out the contagion.

Borrowers may look for ways to avoid a breach by seeking covenant holiday, waivers or other amendments. They may also use equity cures, make prepayments, or even obtain additional equity infusions to help avoid or fix an issue before it becomes a default. While these capital infusions may evidence sponsor confidence and support for the business, private credit lenders should consider whether there are aspects that could be tightened up in the documentation.

Meanwhile, we have been anticipating headwinds and the potential for increase in defaults and restructurings. COVID-19 has certainly increased those headwinds particularly for directly affected industries such as travel, sports & entertainment, gaming, retail and energy. We have direct industry related expertise in these and many other industries and we have written a number of articles for private credit lenders to consider in circumstances of portfolio stress. Here is the list of articles: Will the Next Cycle Be Different, Private Credit Prepares for the Next Cycle, Private Credit Restructuring Year in Review. One key takeaway is that proactive lenders tend to have better results.

The Private Credit Group and **The Private Credit Restructuring Group** at Proskauer is available to help you understand these complex issues and strategize how best to anticipate and respond in these fast changing times.

For additional resources, please visit Proskauer's Coronavirus Resource Center.