

The novel coronavirus impact on secured loans: Considerations for secured lenders and borrowers



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The novel coronavirus outbreak already has impacted numerous industries across the world and caused heavy distress on the global financial markets. The spread of the coronavirus will lead to uncertainty in the commercial secured lending markets as lenders and borrowers begin to discuss and review their loan documents to determine what provisions will need to be addressed as a result of the coronavirus. We anticipate that the vast majority of these discussions will lead to a need to modify certain loan documents. We have prepared this alert to help lenders and borrowers identify some issues that should be considered due to the impact of the coronavirus. Specifically, lenders and borrowers should pay careful attention to the following provisions in a credit agreement and related loan documents now more than ever:

- **Interest rate floor:** Credit agreements often include interest rate floor language that prevents an interest rate from falling below a certain percentage. The interest rate floor in most credit agreements is zero. But with benchmark interest rates falling because of the coronavirus, lenders may seek to increase the floor to avoid the problems raised by negative interest rates.
- **Borrowing base availability:** For revolving loans that include a borrowing base component, the coronavirus crisis could greatly decrease a borrower's availability under the loan due to declining values of such borrower's inventory and receivables. Borrowers may request temporary changes to the borrowing base to increase borrowing availability either through changes to the advance rates, changes

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to eligibility requirements or requesting advances in excess of borrowing base availability. Lenders may get comfortable with these adjustments since most credit agreements grant the lender broad discretion to implement reserves against the borrowing base.

- **Payments:** If a borrower's cash flow decreases significantly, borrowers may request that lenders either defer interest payments or modify the credit agreement to decrease the frequency of such interest payments (i.e., required interest payments moved to quarterly from monthly for a short time period). Similarly, if credit agreements include mandatory principal payments or prepayments, borrowers may request these payments be deferred to maturity. When coming up with a solution to the problems caused by the coronavirus, borrowers and lenders should review the payment terms to determine if temporary adjustments could alleviate such problems.
- **Financial covenants:** The short-term impact of the coronavirus may not accurately reflect the long-term health of certain borrowers. The projections provided by borrowers for this fiscal year most likely did not contemplate the coronavirus and its economic impact. In addition, when testing financial covenants for compliance purposes, most tests look back to the trailing twelve month period and the negative impact of the coronavirus outbreak could last well into 2021. When dealing with this crisis, lenders may consider eliminating or revising certain testing periods for its financial covenants, and when testing resumes, do so on a build-and-roll basis rather than a trailing-twelve -month basis. Borrowers and lenders should review the definition of "EBITDA" in the credit agreement for add-backs for extraordinary, non-recurring or one-time events or losses and determine if this definition needs to be amended. When agreeing to make these accommodations to borrowers, lenders may consider including an equity cure concept that allows the owner to infuse cash equity to avoid an upcoming default.
- **Reporting requirements:** While credit agreements typically require borrowers to report events having a material negative impact on the value of a secured lender's collateral (especially accounts receivable and inventory) and other material events, lenders also may want to consider adjusting the frequency with which borrowers deliver borrowing base certificates and compliance certificates, as applicable. Lenders and borrowers should also review any catch-all reporting provisions in their credit agreements requiring the borrower to report certain information requested by the lender.
- **Events of default and default waivers:** Finally, lenders and borrowers must also consider how the coronavirus' impact may lead to an event of default under a credit agreement. One of the most obvious events of default that comes to mind is the occurrence of a material adverse event, effect, or change (for purposes of this article, we will refer to such an event as a "MAE"). While the determination of whether a MAE has occurred hinges on the presence of **several factors**, the significant negative economic impact the coronavirus could have on a borrower's business and the duration of the borrower's resulting poor performance could constitute a MAE under a credit agreement. Likewise, the interruption of a borrower's business is more likely to occur because of the macro-economic effect of the coronavirus on business operations. Lenders and borrowers should check business interruption provisions to determine the number of successive days of business interruption there must be in order to constitute an event of default, and how, if at all, "business interruption" is defined in the credit agreement. If a borrower has loans with third-party lenders, lenders should also consider whether or not the borrower could be in default under those third-party loan agreements, triggering a cross-default provision in the credit agreement. In response to a borrower event of default, lenders can reserve and/or exercise their rights and remedies pursuant to the credit agreement. Borrowers should review the event of default

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provisions in their credit agreement(s) as soon as possible if they believe they could trip any representations or covenants in their credit agreements that could result in an event of default. Good communication between lenders and borrowers will be crucial during this unique crisis.

The needs of lenders and borrowers with respect to the foregoing provisions in a credit agreement will vary depending on borrower, industry and deal-specific circumstances. The attorneys in McDonald Hopkins' commercial finance practice group advise lenders and borrowers in all aspects of secured lending transactions. Our deep knowledge of the foregoing provisions in loan documents leaves us well-positioned to help lenders and borrowers navigate their financing needs. Please feel free to contact one of the McDonald Hopkins attorneys below to discuss your current needs.



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