What's Market: 2020 Mid-Year Trends in Large Cap and Middle Market Loans

PRACTICAL LAW FINANCE

EXPERTS' VIEW: JEFFREY ROSS AND RYAN RAFFERTY, DEBEVOISE & PLIMPTON LLP

Jeffrey and Ryan discuss COVID-19 and its impact on material adverse effect and liquidity.

Companies must adapt to an economy significantly impacted by the COVID-19 pandemic. In your practice, what have been some of the most important issues to borrowers and lenders since the outbreak? What do you anticipate for the second half of the year?

From the outset of the COVID-19 pandemic, the extent of the virus' impact on any given company's business and cash flows has been exceedingly difficult to predict. In this uncertain environment, it has been critical to ensure that companies have access to liquidity sufficient to allow them to withstand the crisis. As a result, the primary area of focus for the vast majority of affected companies in this initial phase of the pandemic has been to maintain access to liquidity under their existing credit facilities and understand all potential sources of additional liquidity. As an initial step, many companies defensively drew on their revolving credit facilities to ensure that their access to that source of liquidity was not later prohibited either due to the creditworthiness of the revolving credit lenders or due to an inability to satisfy draw conditions (including uncertainty as to whether they might be able to bring down representations or certify the absence of any default). As a second step, many borrowers have examined their existing credit facilities for debt, lien and investment capacity (particularly, priming capacity) that may be used in a liability management transaction to access additional liquidity.

As a result of the dislocation of the secondary trading markets caused by the COVID-19 pandemic, we have also seen many private equity sponsors and debt issuers exploring the possibility of acquiring debt securities and syndicated bank loans at discounted prices. While these buying opportunities create the potential for a company to efficiently retire a portion of its existing indebtedness or for a private equity sponsor to make a further investment in an existing portfolio company, any potential acquirer must be mindful of the various legal and practical considerations that affiliated debt purchases present, including US federal and state securities law considerations, restrictions under existing debt agreements, governance and fiduciary obligations, tax consequences and bankruptcy treatment.

For the second half of 2020, we expect financing activity to be dependent to a significant extent on whether or not the nation is able to contain the COVID-19 pandemic. If not and there is a resurgence of stay-at-home orders and other impairments of the economy more generally, we expect debt issuers and lenders to continue to be conservative, with debt investors favoring high-quality investments and seasoned issuers with business models that are less susceptible to the impact of COVID-19 related containment measures. If we as a nation are able to contain COVID-19 and the national economy continues to reopen, we expect an increase in financing activities as debt issuers more actively pursue opportunistic financing and M&A activity returns to pre-COVID-19 levels and, perhaps, surges above those levels as buyers' and sellers' price expectations converge.

Finally, as the negative impact of COVID-19 on some borrowers' performance continues, we expect to see the increased stress to be reflected in some borrower's liquidity position, potential non-compliance with financial covenants, inability to address near term maturities and possible going concern qualifications in audit opinions in the next season which, for borrowers who operate on a non-traditional fiscal year, may occur prior to the end of the calendar year. In this context, we also expect to see disagreements between borrowers and lenders over EBITDA addbacks, requests for covenant relief and/or additional out-of-court and in-court restructurings.

How are borrowers and lenders addressing COVID-19 in the context of the negotiation of material adverse effect (MAE) definitions and those loan agreement provisions that incorporate MAE?

Most loan agreements include a representation that, since the original closing date, there has been no development or event

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relating to or affecting the borrower which has had or would be reasonably expected to have a MAE. Most representations in loan agreements also include an exception for items that have not had and would not reasonably be expected to have a MAE. The definition of MAE in loan agreements is typically fairly generic, and does not include the many exceptions that are typically negotiated into the equivalent acquisition agreement definition.

We expect variations from this customary framework to be limited and relatively narrowly tailored. While new loan issuances have been limited since the initial onset of the COVID-19 pandemic, we have seen and expect to continue to see financial sponsors and savvy corporate borrowers seeking to include a COVID-19 related exception to the definition of MAE. In one recent transaction for a sponsor-backed borrower, the definition of MAE included a carve-out for events, developments and circumstances related to the COVID-19 pandemic that were disclosed to the lenders, or otherwise disclosed in the company's public filings on or prior to the closing date. We do not, however, expect to see broad exceptions to the definition of MAE for pandemics generally, as has become common in acquisition agreements.

Since the onset of the COVID-19 pandemic, many borrowers have considered drawing down existing revolvers to shore up their cash positions and preserve liquidity. In your experience, how widespread is this trend and how have lenders responded?

As described above, since the outset of the current COVID-19 pandemic, companies have been acutely focused on maintaining their cash positions and preserving liquidity. One means of achieving these goals is for companies to defensively borrow under their existing revolving credit facilities. This practice was widespread in the early stages of the pandemic for borrowers of all sizes and transcended industry sectors regardless of the direct effect of COVID-19 on their businesses. Consistent with this theme, some financial sponsors applied this practice across their entire portfolio, even if some portfolio companies were relatively healthy and minimally impacted by COVID-19. More recently, we have seen a trend toward some borrowers repaying some or all of the excess cash that was borrowed as some of the risks originally identified have diminished and the cost of the revolver borrowings outweighed these risks.

We generally saw little resistance from the lender community in response to the defensive borrowings. However, some lenders took the opportunity to remind borrowers about their obligation to satisfy all draw conditions, including, if applicable, a bring down of the no MAE representation. Under New York law, the threshold for the occurrence of a MAE is high. To constitute a business-related MAE, the resulting impact would have to be significant in terms of magnitude and the effect would need to persist for a durationally significant period of time (typically measured in years rather than months). To date, most borrowers have been comfortable making this representation. However, if the COVID-19 pandemic continues to persist, there may come a time when some borrowers cannot make this representation and, in turn, cannot satisfy the conditions to borrowing under their revolving credit facility.

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