March 18, 2020

Credit Fund Lenders and Impact of Covid-19 on Credit Investments

Attorneys
Leonard Klingbaum
Alyson Gal
Joanne De Silva
Jessica Taylor O'Mary

The disruption resulting from the coronavirus has already had profound implications for credit fund lenders. These lenders are preparing for potential work-out or bankruptcy scenarios, or at a minimum amendment discussions centered on liquidity issues and covenant breaches, and some are positioning to take advantage of the possible opportunity set. Others have seen unusually high credit activity and draws on revolvers or delayed-draw tranches, for example.

Our current thoughts on some issues facing credit fund lenders are below, followed by potential immediate next steps that such lenders should consider.

A. Potential Immediate Issues Facing Borrowers and Impacting Lenders

1. MAC/MAE Provisions. Lenders and borrowers alike are reviewing material adverse change and material adverse effect clauses in their loan documents (collectively, "**MAC Clauses**"). MAC Clauses usually include several prongs, including the potential or actual impact on a borrower's business and the impact on a borrower's ability to perform under its loan documents. Certain MAC Clause definitions may also include events that have had, or could have, a material adverse effect on the borrower's prospects, though such formulations are more lender-friendly and often have been successfully resisted by borrowers.

   A MAC Clause typically comes up as a condition to borrowing, either directly, or as a qualifier to representations that must be brought down at the time of each borrowing. Under New York law, a MAC Clause is not usually considered to have occurred in the absence of an event that satisfies a durational component. Of course, this component may be of less significance if a borrower's industry is one that is immediately materially adversely impacted (*e.g.*, cruise lines, airlines, tour operators, oil and gas companies). A lender's decision to withhold funding on the basis solely of a MAC Clause having being tripped, however, is a decision that should not be taken lightly as the risk of taking an aggressive stance to a lender may be material in light of the potentially disastrous impact on a borrower's liquidity.

   MAC Clauses also may result in an event of default in certain loan documents, albeit this is much less common. The determination to declare such an Event of Default, while probably presenting less risk to a lender, also should be considered carefully under the circumstances. As mentioned above, the assertion that a MAC Clause has been tripped typically requires some durational component, and as such may be premature to evaluate.

2. Audit Deliveries. Most loan facilities require that an unqualified audit be delivered within 90-120 days from the end of a borrower's fiscal year. However, we anticipate that many borrowers will be unable to comply timely with the delivery timeframe given that many audit firms have pulled audit teams off client sites, calling into question the ability to complete audits within the usual time periods. Moreover, many borrowers will need to reforecast 2020, resulting in recalculating their ability to comply with covenants and/or liquidity

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2020 Ropes & Gray LLP

ATTORNEY ADVERTISING

needs. For this reason, borrowers and their auditors may need additional time to evaluate going concern issues, which may further delay audit completion.

A delay in delivering audits and/or the inability to deliver unqualified audits may triggers events of default under loan documents.

We recommend reviewing loan documentation now and discussing with borrowers their anticipation around unqualified audit deliveries.

3. Maintenance Covenants/Springing Covenants. Some loan documents will include financial maintenance covenants that may become more difficult, if not impossible, to satisfy in light of business deterioration. Businesses that annualize results from the most recent quarter in their covenant calculations will face covenant issues more quickly than those that employ a standard LTM approach.

   Some loan facilities include a springing covenant that becomes applicable based on revolver usage or availability. Such formulations trigger as availability reduces (including as a result of borrowing base deterioration) and/or revolvers are utilized. Even absent revolver draws, availability may decline as a borrowing base shrinks, which may occur as inventory shrinks and/or receivables are paid (and not replaced), or become ineligible if account debtors are unable timely to pay.

   We anticipate that borrowers facing financial covenant defaults on account of the COVID-19 situation may explore aggressive reads of financial definitions to justify adjustments to financial covenant calculations.

4. Revolver Draws. There has been unprecedented activity among borrowers seeking to shore up liquidity through drawing on revolvers. This, in turn, likely will drive immediate pressure on credit fund lenders to shore up internal availability of liquidity to cover revolver draws and anticipated revolver draws.

B. Potential Immediate Next Steps for Lenders

1. Information Rights. Most loan documents will contain broad rights for agents and/or lenders to seek additional information. Given the foregoing potential issues, lenders should consider the scope of their information rights and consider exercising such rights pre-emptively. This may be most applicable in the context of outstanding commitments and borrowers' requests to draw additional funds, but can also be important as a means to gather information to push back on aggressive financial covenant calculations and to prepare for waiver and forbearance discussions.

2. Defaults as Opportunities. Lenders can expect to be approached by borrowers seeking additional liquidity, covenant relief and/or extra time to deliver audits and other reporting. They should take this opportunity to evaluate their documentation and collateral and to consider whether appropriate to seek improvements in documentation, remedial rights (e.g., elimination of procedural requirements for the exercise of equity pledges), collateral and/or economics as part of the waiver process. In addition, managers of older funds or funds with less liquidity in particular should assess whether existing funds have flexibility to provide additional financing and if other pools of capital could be used for refinancing or rescue financing, and what conflicts of interest will be implicated.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2020 Ropes & Gray LLP

ATTORNEY ADVERTISING

3. Ensuring Availability of Liquidity. All lenders should be assessing their exposures in view of the foregoing and the situation in general, and develop liquidity measures including through back-up options, in light of the rapid and evolving changes in market conditions.

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2020 Ropes & Gray LLP

ATTORNEY ADVERTISING