Taking stock: key considerations around the impact of COVID-19 on existing loan arrangements

April 2020

In this publication we look at the issues facing borrowers, the potential effects of COVID-19 on existing loan arrangements, and some pitfalls to avoid.

One eye on the past, one eye on the future

Coronavirus has already damaged large swathes of businesses across the world. Whilst officials expect the pandemic to peak in the UK in April, there are no indications that its impact on the economy will abate. With the majority of economists now predicting a more sustained "U" shape recovery (as opposed to the previously predicted sudden but brief "V" shape recovery) this trend looks set to continue for the foreseeable future.

With many businesses already feeling the impact on their cashflow, efforts are understandably focused on obtaining additional financing to see their business through this downturn in the economy.

Businesses are seeking new loans, whether via conventional debt facilities, or by utilising the Coronavirus Business Interruption Scheme (CBILS) or the Covid Corporate Finance Facility (CCFF) as part of the suite of measures announced by the Government in March 2020. To date, there has been modest uptake for either initiatives. However, it is early days and on 3 April 2020, the Government announced significant changes to the CBILS and the introduction of a new Coronavirus Large Business Interruption Loan Scheme (CLBILS) for businesses with a turnover of between £45 million and £500 million.

Whether or not looking to obtain additional finance, businesses should review their current financing arrangements to ensure that they are ready to deal with any issues they might encounter in the current and expected economic circumstances, review the potential impact of those issues on future plans, and work out what can be done about it.

Breaches, breaches, breaches

For most loans, the pandemic itself won't constitute a breach of their terms or the terms of any related finance documents. However, the indirect impact on businesses' financial performance and operations (and potentially on the wider economy) may result in borrowers falling foul of certain provisions.

Obvious breaches like non-payment, failing financial covenants or insolvency will constitute a default under standard loan documentation. However, there are lesser-known provisions which will also result in defaults occurring. These relate to:

- events or circumstances giving rise to a material adverse effect / material adverse change;
- any attempt by the borrower to reschedule indebtedness with any of its creditors (possibly including the lender);
- cross defaults under the terms of any agreements between the borrower and third parties;
- debt undertakings (in particular, restrictions on the borrower incurring financial indebtedness to third parties);
- negative pledges prohibiting the borrower from granting other security in favour of third parties; and
- intercreditor arrangements governing the inter-relationship between the rights of multiple lenders.

At this juncture, we should note that these provisions are market standard (and included in the Loan Market Association standard documentation widely used in the market) and therefore are rarely negotiated. Where such provisions are negotiated, these tend to be relatively minor amendments.

These provisions are explained below. Note that this is not an exhaustive list and we recommend speaking to your professional advisors if you are unsure as to the terms of your loan. Any references in this article to default events (often defined as "Events of Default" or "Termination Events" in loan documentation) do not apply to "on demand" facilities such as overdrafts, where the lender may elect to terminate the facility at any stage.

Why does it matter to your business?

Where a breach of a finance document constitutes a default event, this will typically entitle the lender to:

- cancel any further commitment to advance funds (a so called "drawstop");
- declare that all amounts owing be immediately due and payable;
- declare that all loans become payable on demand;
- exercise its rights to recover all amounts owing, including the enforcement of its security (if any); and/or
- charge default interest on any indebtedness owing (the rate will vary however for loans from any of the clearing banks this is usually in the region of 2% above the usual contractual rate of interest).

In most cases, we would expect that the lender will seek to understand the reason for a breach and look to find ways to assist the borrower in resolving the underlying problem in the first instance (see the below section entitled "*How will existing lenders react to an event of default?*"). However, where a lender is not willing or able to engage with a borrower on this basis, and has resolved to move to the enforcement phase, it will have a range of tools available to it. Here, lenders will primarily look to enforce any security (including third party security) provided in connection with the loan (e.g. debentures, legal mortgages over properties, assignments over account deposits etc.), as well as to recover under any guarantees.

The right to take enforcement action may be affected by the Government's proposed changes to UK Insolvency legislation in response to COVID-19. As announced by Alok Sharmawhich (Secretary of State for Business, Energy and Industrial Strategy) on 28 March 2020, this will include the introduction of a moratorium (a period in which creditors cannot take action whilst a business considers its restructuring options) and restricting creditors from presenting winding-up petitions. Full details of the proposed changes have yet to be announced, however we will be posting updates on our COVID-19 hub.

Material Adverse Effect (MAE) / Material Adverse Change (MAC)

What is an MAE clause?

MAE clauses are almost always included in loan agreements. Their purpose is to act as a "sweeper" to allow the lender to take action when the lender feels its position has been prejudiced in a way which is not otherwise provided for in the loan agreement. On the face of it, COVID-19 is precisely the sort of event that an MAE clause is designed to cover (i.e. one that could not have possibly been foreseen when the loan was entered into by the parties).

A standard loan agreement will include a concept of "Material Adverse Effect" to qualify various obligations, including certain representations and undertakings. This means that certain events (for example non-compliance with environmental undertakings) will only result in a default if they have a Material Adverse Effect. This is useful because it protects the borrower against the risk that a minor breach of the loan agreement allows the lender to call in the loan.

The flip side of this is that loan agreements will usually also include an MAE specific event of default clause. This will be drafted along the following lines (this being the Loan Market Association's standard wording) and will provide that a default event will occur if: *"any event or circumstance occurs which the Lender [reasonably believes] has or is reasonably likely to have a Material Adverse Effect."*

The precise definition of Material Adverse Effect will vary from loan agreement to loan agreement. The Loan Market Association defines MAE for leveraged and real estate finance transactions as follows:

"**Material Adverse Effect**" means [in the reasonable opinion of the Majority Lenders] a material adverse effect on:

a. the business, operations, property, condition (financial or otherwise) or prospects of the Group taken as a whole; or
b. [the ability of an Obligor to perform [its obligations under the Finance Documents]/[its payment obligations under the Finance Documents and/or its obligations under Clause [•] (Financial condition)]]/[the ability of the Obligors (taken as a whole) to perform [their obligations under the Finance Documents]/[their payment obligations under the Finance Documents and/or their obligations under Clause [•] (Financial condition)]]; or
c. the validity or enforceability of, or the effectiveness or ranking of any Security granted or purporting to be granted pursuant to any of, the Finance Documents or the rights or remedies of any Finance Party under any of the Finance Documents.]

Note that this is a relatively complex, "lender friendly", formulation of Material Adverse Effect and borrowers should check the terms of their own loan agreements to see how Material Adverse Effect is defined.

What is an MAC clause?

Like MAE clauses, MAC clauses are intended to protect the lender in cases where there is change in events of circumstances. The concept of Material Adverse Change appears, as standard, in certain of the representations made by the borrower to a lender within a loan agreement. Whilst the drafting will vary, most loan agreements will contain the following standard representations dealing with MAC (this being the Loan Market Association's standard wording):

- *"There has been no **material adverse change** in its assets, business or financial condition (or the assets, business or consolidated financial condition of the Group, in the case of the Parent) since the date of the [Accountants' Report/Original Financial Statements]."*
- *"Since the date of the most recent financial statements delivered pursuant to Clause [x] (Financial statements) there has been no material adverse change in the assets, business or financial condition of the Group."*

These MAC representations tend to be repeating representations. For borrowers, this means that such representations will be made both during the course and aftermath of the pandemic. A breach of these representations (possibly after the expiry of a grace period) will be an event of default.

Unlike Material Adverse Effect, the concept of "material adverse change" is undefined in most loan agreements. However, it tends to be linked to a change in the assets, business or financial condition of the borrower. The fact that the material adverse change isn't dependant on a borrower's ability to fulfil its obligations under the loan agreement means that even if the borrower remains ultimately profitable, the very fact there is a decline in financial condition of the borrower could be a breach.

That said, one way borrowers may benefit from these MAC representations being linked to the date of their previous financial statements is that, such representations won't be breached if there is a gradual decline in the business' financial performance over a number of years; with each year's decline being "immaterial" for the purposes of the MAC representations but which taken in aggregate, would otherwise constitute a material adverse change. Unfortunately, this will be of little comfort to many borrowers dealing with COVID-19, where the impact on the business' financial health is likely to be stark and sudden.

For a detailed analysis of MAE / MAC clauses in the context of COVID-19, please see our article Will COVID-19 constitute a material adverse effect and/or material adverse change under existing loan arrangements?

Rescheduling of indebtedness

Evidence suggests that more and more businesses are approaching their creditors in response to COVID-19, as their revenues continue to decline. This includes landlords, suppliers, HM Revenue & Customs and banks and other institutional lenders.

Whilst early engagement with creditors will be crucial to ensuring the long-term sustainability of many businesses, borrowers should be mindful of the unintended consequences this may have with respect to their loan arrangements. Specifically, most loan agreements will contain an event of default along the following lines:

"[The borrower] by reason of actual or anticipated financial difficulties, commences negotiations with one or more of its creditors [(excluding any Finance Party in its capacity as such)] with a view to rescheduling any of its indebtedness."

As with MAE / MAC clauses, there is limited case law on what "rescheduling" and "negotiations" mean in this context. The two main authorities are:

- *Torre Asset Funding Limited v The Royal Bank of Scotland plc* [2013] EWHC 2670 (Ch); and
- *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L.* [2013] EWHC 1039 (Comm).

These cases have provided the following guidance:

- Formal: the words "rescheduling" means there must be a degree of formality which relates to *"the formal deferment of debt-service payments and the application of new and extended maturities to the deferred amount."* For instance, informal catch-ups with your relationship manager at your bank will unlikely be an attempt to "reschedule". However, it will apply to more formal requests which can be made in any number of ways, including via email.

- Substantial: the common requirement that negotiations be commenced because of "actual or anticipated financial difficulties", will only be satisfied if such difficulties are of a "substantial" nature. Whether or not such anticipated financial difficulties are substantial will depend upon the drafting of the clause and the factual matrix of the agreement in question. However, the courts will approach this determination in much the same way as it does when considering MAE / MAC clauses (see above).
- Ordinary course of business: communications with creditors in the ordinary course of a business (which may include rolling over existing indebtedness) will not qualify as "negotiations for debt rescheduling". However, where such negotiations follow the maturity of an existing loan, with a view to rolling into a new loan, this will qualify as the request to roll is inherently linked to non-payment of the existing loan and the consequent threat of legal action.

Whether or not such provisions include the wording "by reason of actual or anticipated financial difficulties" will have a marked impact on whether an event of default has occurred. Where such wording is included (as is commonly the case), the borrower will be protected where negotiations are instigated not because of any financial difficulties, but as a matter of general business prudence. Of course, there are no hard and fast rules dictating how far into the future "anticipated financial difficulties" extends, so on a literal interpretation every business decision will be made with one eye on the "anticipated financial difficulties". However, the fact that such provisions appear within the "Insolvency" section of the events of default (at least in LMA documentation), and by reason of the rule of *ejusdem generis* (latin for "of or as the same kind"), we consider that there must be some degree of imminence to any anticipated financial difficulties. For example, steps taken by a business to reschedule a commercial mortgage not falling due for 10 years will clearly not be done with a view to anticipated financial difficulties.

Ultimately, whether or not approaching a creditor will constitute a default event will depend on a variety of factors, including the manner and reason for the approach.

What about negotiations to reschedule indebtedness with your existing lender?

Something borrowers may not appreciate, is that approaching their existing lenders (e.g. with requests for repayment holidays) may constitute an event of default. This is the case if the loan agreement does not contain a carve out for such negotiations. Note that for businesses with borrowings from a private equity lender where a representative of that lender has board observer rights, the very discussion of rescheduling indebtedness at board meetings could be a default.

Of course, it is acknowledged that many businesses will be making approaches to their lenders to discuss rescheduling their indebtedness. Moreover, our experience is that most lenders will be receptive to this proactive approach. Whilst there is no general implied duty of good faith on behalf of lenders towards borrowers, it would be extremely rare (and almost inconceivable) for a lender to use such an approach as leverage against a borrower However, borrowers should nevertheless be aware of the possibility of lenders opportunistically calling an event of default for this.

To avoid tripping an event of default, borrowers may consider contacting their lenders for a formal consent before discussing any proposed rescheduling (whether with the existing lender or other creditors). Where possible, any approach should be couched in terms so that it is clear that the borrower is financially stable, that the request is not being made in connection with any current or anticipated financial difficulties, but asking the lender to confirm that should matters change, the borrower is permitted to approach creditors to discuss deferment of payments etc. We can assist, including draft wording if required.

What about negotiations to reschedule indebtedness with HMRC?

One particular creditor which most businesses will be engaging with as a result of COVID-19 is HM Revenue & Customs. It is our view that there is a distinction here between the deferment of VAT, and the deferment of other tax liabilities (e.g. corporation tax and PAYE). Please refer to the government website for further details, but broadly speaking the following measures have been introduced in response to COVID-19 with respect to VAT, corporation tax and PAYE:

- Value Added Tax: for UK VAT registered businesses which have a VAT payment due between 20 March 2020 and 30 June 2020, VAT payments may be deferred until a later date. This is an automatic offer with no applications required. The businesses will not need to make a VAT payment during this period and will be given until 31 March 2021 to pay any liabilities that have accumulated during the deferral period.
- Corporation tax and PAYE: may be deferred pursuant to a Time to Pay arrangement (TTP) with HMRC. This, in itself, is a not a new measure, but we would anticipate HMRC being more amenable to requests for a TTP given the current climate.

Whilst any borrower looking to defer tax liabilities should seek specialist tax advice, our preliminary view is that not paying VAT in accordance with the government's offer would not qualify as "rescheduling of indebtedness", whereas arranging a TTP would. This is because the deferment of VAT is an automatic offer with no applications required. Further, the deferment of VAT will not necessarily be done with respect to anticipated financial difficulties; rather, a business may simply wish to shore up its cash reserves by utilising HMRC's offer to defer its VAT liabilities. This is different to a TTP, which will involve substantial negotiation with HMRC to agree the terms of any debt rescheduling, and HMRC will only agree a TTP if it is satisfied that the borrower is or will be experiencing financial hardship which prevents it from discharging its tax liabilities on time.

Cross default

In the majority of loan agreements, it will be an event of default if any other financial indebtedness is not paid or there is a default event in relation to such indebtedness (a so called "cross default"). Accordingly, borrowers cannot rely on paying the lender under their primary loan arrangement at the expense of other creditors. Further, borrowers should be mindful of any overlapping provisions in other agreements, particularly where such provisions are more onerous than their primary loan arrangement. In effect, a loan agreement could be brought down by an event of circumstance which would not be an event of default in its own right under such loan agreement, but by virtue of it being an event of default under another agreement. For example, one loan agreement may provide that it is an event of default if any payment is not made when due, subject to a grace period of three business days.

However, a second loan agreement may not allow any grace period, such that non-payment will immediately cause a cross default under the first loan agreement. Equally, it may be an event of default under one loan agreement if the business' auditors qualify the audited annual financial statements of the borrower, whereas a second loan agreement may require that such qualifications must have a Material Adverse Effect.

Notwithstanding this express carve out, the second loan agreement may nevertheless be breached by virtue of the cross default under the first loan agreement.

Some loan agreements will contain *de minimus* limits, such that non-payment of other financial indebtedness will not constitute a default event provided financial indebtedness not paid is less than £X. We anticipate that some business will be forced to rely on these *de minimus* limits. However, we would caution against non-payment if possible, particularly if there is a realistic prospect of such creditors taking enforcement action (e.g. by way of litigation, winding up proceedings etc.). Such enforcement action could, in itself, constitute an event of default under different provisions.

Debt undertakings - restrictions on financial indebtedness

Most loan agreements will contain an undertaking, pursuant to which the borrower agrees that it will not incur or permit to be incurred any financial indebtedness (subject to any "permitted financial indebtedness" negotiated when agreeing the loan). This means that the borrower may well be prohibited from obtaining loans from other lenders. If existing lenders are not willing to make available additional financing themselves, this will severely limit a business' options for alleviating cashflow pressures. Any restriction in existing loan arrangements will extend to any financial indebtedness incurred under the CBILS, CCFF or CLBILS. This is important, as the very measures which the Government has introduced may be rendered useless by such restrictions.

Note that such restrictions will not affect businesses' ability to obtain grants, such as the Government's Small Business Rate Relief, Rural Rate Relief, Retail and Hospitality Grant Scheme or Economic Resilience Fund, as these should fall within the definition of financial indebtedness.

Negative pledge

Most loan agreements and security documents will contain a negative pledge which provides (usually subject to some limited exceptions) that the borrower cannot, without the lender's consent, grant any security over its assets other than in favour of the lender. Failure to observe this restriction will be a breach of the loan arrangements.

Whilst some lenders may not require security, it is anticipated that most will. Certainly, in accordance with the current guidance issued by the Government in relation to the CBILS, borrowers may have to provide security where possible for overdrafts, term and other facilities (albeit personal guarantees will not be required for facilities under £250,000).

Intercreditor arrangements

Where there are a number of creditors, borrowers should consider restrictions in any existing intercreditor arrangements, including restrictions on incurring further indebtedness or rescheduling any indebtedness.

If a business is obtaining additional funding from another lender, it is likely that existing lenders will require the parties to enter into a deed of priority / intercreditor agreement. This will govern, among other matters, the ranking of the lenders' respective debts and the priority of any security being granted. Existing lenders will likely stipulate that they must rank first in priority to the new lender with respect to any indebtedness and security.

How will existing lenders react to an event of default?

How financial institutions will react to events of default caused, directly or indirectly, by COVID-19 has yet to be fully tested. Provided a borrower is servicing its payment obligations, we would expect lenders to take a pragmatic approach to any default events. For major lenders, there are reputational issues to consider. Our experience over the past few weeks is that where possible, banks are willing to engage with their customers to help them through this crisis. We have seen many requests to document waivers for breaches, and to amend loan agreements to grant capital repayment and/or interest holidays. To date, we have not seen a spike in lenders looking to accelerate loans and enforce their security.

What can you do to protect your business?

The steps taken by existing borrowers will depend on the issue(s) they are seeking to address.

In some cases, the terms of the loan documents themselves may offer a solution. For example, when dealing with a breach of financial covenant, the loan agreement may contain "cure rights", giving the borrower the option to resolve matters by injecting further equity or by providing additional security to the lender. However, exercising cure rights may be undesirable from a business perspective in this current climate; particularly with respect to equity injections where cash is needed elsewhere.

In other cases, short-term fixes may include obtaining a waiver from the lender for a one-off breach. These are typically documented by way of a short form letter from the lender. Longer-term measures may involve refinancing the loan with the existing or new lender, or agreeing amendments to the existing loan arrangements (such as capital repayment holidays and rolling up interest). See our article on how to amend your current loan agreements here.

If approaches are to be made to creditors (whether this be the existing lender or other creditors), careful consideration should be given to the manner and nature of these approaches, to avoid breaching the terms of any existing loan arrangements.

In all cases, we suggest that all borrowers should review the terms of the current loan arrangements, to ensure they are well placed to deal with any current or anticipated issues. If you are unsure of the nature and effect of any provisions, we advise seeking professional advice at the earliest opportunity. Your advisors should be able to create a roadmap identifying any hazards to avoid, bridges to cross, any likely bumps in the road.

How Blake Morgan can help

Blake Morgan can advise on the terms of your existing loan arrangements, and assist you with any measures required to see your business through these difficult times. Please contact Rebecca McCabe-North, Jake Holmes or Kath Shimmin.

Rebecca McCabe-North,
Partner

D: 0118 955 3007

M: 07899 065225

E: Rebecca.McCabe-North@blakemorgan.co.uk

Jake Holmes,
Senior Solicitor

D: 0118 955 3019

M: 07795 540378

E: Jake.Holmes@blakemorgan.co.uk

Kath Shimmin, Partner
(Head of Banking & Finance)

D: 023 8085 7081

M: 07899 065248

E: Kath.Shimmin@blakemorgan.co.uk

CARDIFF

Tel: 029 2068 6000

Fax: 029 2068 6380

LONDON

Tel: 020 7405 2000

Fax: 0844 620 3402

OXFORD

Tel: 01865 248607

Fax: 0844 620 3403

PORTSMOUTH

Tel: 023 9222 1122

Fax: 0844 620 3404

READING

Tel: 0118 955 3000

Fax: 0118 939 3210

SOUTHAMPTON

Tel: 023 8090 8090

Fax: 0844 620 3401

Email: info@blakemorgan.co.uk

Web: www.blakemorgan.co.uk

LinkedIn: Blake Morgan LLP

Twitter: @blakemorganllp

Facebook: @blakemorganllp