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Financial Services in the Time of COVID-19: Defaults Under Credit Agreements and Options for Lenders in Response

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The global COVID-19 pandemic presents extraordinary challenges for all participants in the financial services industry. The timing, expanse and severity of the situation means that lenders and borrowers will need to quickly explore the implications and consequences of the crisis on the ability of a borrower to meet its obligations under a credit agreement, as well as the options available to mitigate the fallout. For lenders, developing a COVID-19 policy and applying it evenly will be paramount, as there will be political and reputational risk considerations in the current climate.

Considerations for Lenders When Developing COVID-19 Response Policies

In the face of such unprecedented events, every lender operating in Canada is developing its own policy with respect to the kind and degree of leeway or tolerance that will be given to borrowers under credit agreements. Some lenders will develop comprehensive policies, while others will deal with issues as they arise on a case-by-case basis. In developing policies, proactive lenders will be considering, among many other things, the following measures to protect against or reduce the chance of defaults:

- **Nature of the Borrower's Operations:** Always have regard to the nature of the business and industry in which the borrower operates. Clearly, the treatment of a borrower in the travel and hospitality industry is going to be different than the treatment of a borrower that provides essential services such as pharmacies and food distribution operations. In some more cyclical industries or businesses that are pivoting in their operational approach (perhaps from making car parts to making ventilators), consider making available new or bulge credit facilities.
- **Consider Reducing Interest Rates:** Consider reducing rates for a temporary period and even relaxing or cancelling certain covenants on a temporary basis.
- **Payments on Term Facilities:** Consider allowing payments of principal and/or interest on term facilities to be postponed for a certain period of time. The postponed amounts may be added to the principal of the loan, and the loan may be extended for a period of time commensurate with the payment postponement period.
- **Blend and Extend:** Consider lowering interest rates and increasing amortization periods.
- **Margins:** Consider temporary amendments to margin formulas, for example, allowing borrowing margins for receivables or inventory to increase.
- **Additional Security:** Consider whether there exists equity in other assets, such as real estate, that might be used to backstop margined working capital facilities, with margin increases.
- **Assistance with Planning and Reporting:** We suggest that lenders not forego or show undue flexibility in borrower financial reporting. Stay vigilant in this regard, even (and especially) in these challenging times. Lenders and borrowers together should also ensure borrowers are being vigilant about curtailing expenses to adjust to new revenue levels. A lender should also encourage its borrowers to approach their other creditors to, where appropriate, obtain payment relief to assist in reducing monthly cash flow commitments.

- **Government Assistance**: All lenders and borrowers should keep informed of the various support programs offered or that may be made available in the future by the federal and provincial governments so that lenders can invite, and their borrower can benefit from, such programs.

Of course, nothing replaces good corporate citizenship and common sense. This is a time when we all need to show tolerance and accommodation, yet, at the same time, both lenders and borrowers will need to be realistic and considerate of whether a business continues to have viability and resiliency going forward, and, accordingly, whether accommodation and creativity will generate a productive result for the long term.

Defaults

Notwithstanding the implementation of preemptive policies by lenders to deal with the health and corresponding financial crisis we all now find ourselves in, the disruption to businesses and resulting economic slowdown caused by COVID-19 will very likely lead to an increase in defaults under credit agreements by affected businesses.

Depending on the specific terms of a credit agreement, defaults generally result from, among other things, a breach of a financial covenant or a reporting requirement, a payment failure or a material adverse change in the financial condition of the borrower. Such defaults may or may not have a cure period associated with them whereby the borrower has a certain period of time within which to cure the default.

The term “material adverse change” is undoubtedly top of mind right now. A borrower being in an industry which is more dramatically affected by the pandemic will not likely in itself constitute a material adverse change (subject to the language in the relevant agreement). However, if that borrower subsequently experiences financial difficulties as a consequence, that deterioration in financial condition could constitute a material adverse change in financial condition prompting a different set of considerations.

Establishing a material adverse change will be a highly subjective process involving careful consideration of the drafting and surrounding circumstances. There is already a lot of industry discussion about relying on material adverse change clauses, but two things are good to remember. First, most credit agreements provide that whether a material adverse change exists is in the discretion of the lender, so a borrower may not ultimately have much say in the matter. Secondly, and more importantly, where a borrower is suffering financial distress as a result of COVID-19, it is likely that other defaults will also exist or arise very quickly, such as a breach of a financial covenant or a payment default. So while a lender may be able to rely on a material adverse change provision to call a default under a credit agreement, it could very quickly find that it is not necessary.

Regardless of the source of a default, if one occurs, it will be time for the lender and the borrower to discuss options. Given COVID-19’s broad economic impact, we expect that lenders will be receptive to a borrower who has an otherwise viable business, and a strategy for emerging from financial distress as Canada emerges from the pandemic. There are a number of options available to lenders and borrowers to address defaults under credit agreements, including amendments providing extensions of the period of time to meet the covenants that have been breached or agreeing to waive the defaults. We have already seen a marked uptick in the number of amendments to credit agreements being completed in the past two weeks.

Forbearance Agreements

If a lender is not prepared to provide an extension or a waiver of a default, the lender may enter into a forbearance agreement with its borrower to allow the borrower an opportunity to reorganize by obtaining alternate financing, an opportunity to sell assets or an opportunity to “right the ship.”

Forbearance agreements will also be important tools for both lenders and borrowers in the coming months. A forbearance agreement often provides the lender with extra time to gather information on the financial situation of the borrower and what its financial needs and prospects will be going forward. For a borrower, entering into a forbearance agreement with its lender will allow the borrower additional time to attempt to stabilize its business operations, seek alternative solutions to remedy any sources of financial distress or facilitate a transaction to sell some or all of its assets outside of a formal restructuring proceeding. In addition, a forbearance agreement might allow a lender or borrower to engage third party

advisers or consultants to assist in identifying the challenges facing the business as well as potential solutions to the financial distress.

The uncertain and changing circumstances brought on by COVID-19 require flexibility on the part of lenders and borrowers alike. As the financial consequences of the crisis manifest, it will be necessary for lenders to develop creative solutions in real time.

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