

Financial Services in the Time of COVID-19: Practical Considerations for Lenders When Dealing With Defaults

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As the global health crisis continues to erode the economic outlook, a material increase in credit agreement covenant defaults is inevitable. In this article, we examine some practical considerations for lenders when dealing with defaults.

Acknowledging Defaults Through Waiver or Tolerance Letters

Upon the occurrence and discovery of a default, a primary consideration for the lender is whether to act on the default immediately through enforcement (an option explored elsewhere), waive the default or preserve its rights to act on the default in the future. A lender's decision is often driven by whether the borrower is a public company that is required to issue a press release in connection with any steps that are taken by the lender.

If the lender wishes to waive the borrower's default, a common approach is to issue a waiver letter. The waiver letter should clearly identify the specific default (typically with reference to the financial reporting disclosing the default) and explain why the default constitutes an event of default, with reference to the relevant sections of the credit agreement. While the letter will then waive the default, it is imperative to clearly indicate that only the specific default is waived, and that the waiver does not apply to any other current or future defaults.

If the lender wishes to reserve its rights to pursue the default, it can prepare a tolerance letter, also known as a reservation of rights letter. Unlike a waiver letter, the lender does not waive the default with a tolerance letter. After clearly identifying the default, and explaining why the default constitutes an event of default, the lender should expressly reserve its rights to act on the default in the future. Ideally the borrower would acknowledge the lender's reservation of rights by signing the letter as an acknowledging party.

As a practical matter, if the lender wishes to amend other aspects of the credit agreement when addressing the default, the waiver or reservation of rights relating to the default will often be incorporated into the credit agreement amendment rather than addressed in a standalone letter.

Addressing Defaults by Amending the Underlying Covenant

In this economic climate, an event of default will often signal that the existing covenant is no longer practical or appropriate. If the lender agrees to amend the underlying covenant, the following are a few useful considerations:

- **Time Period:** should the amendment be a temporary or permanent change to the covenant?
- **Financial Projections:** should existing financial projections be revisited?
- **New Covenants:** would different financial covenants now be more appropriate?
- **Additional Reporting Requirements:** would new or additional reporting requirements be necessary in light of changes to certain covenants?
- **Triggers or Thresholds:** are existing covenant triggers or thresholds still appropriate?

Reviewing Existing Security

The occurrence of an event of default will often represent an opportunity for the lender to review its existing security. By conducting a security review, lenders can identify and rectify any errors with its existing security. The most common errors disclosed in a security review relate to personal property security registrations, including filing errors, expired registrations and the failure to perfect in all jurisdictions where the borrower has tangible assets. A comprehensive security review will also assess whether the existing security is substantively sufficient from an economic perspective; there may be opportunities to add security against specific assets or to obtain new security from related parties.

Anti-Hoarding

Although we are at the early stages of the pandemic, many lenders have already noticed that some borrowers are drawing down large amounts of cash out of concern that banks will not make the funds available to borrowers. To prevent this practice, lenders may want to consider adding anti-hoarding language into its existing lending agreements. The clause contemplates that borrowers will only draw on funds for the purpose of meeting its costs and expenses in the ordinary course of business, within a given time frame (such as within 10 days from the date of the advance).

Conducting Due Diligence

A credit agreement amendment in the context of a default also provides an opportunity to refresh due diligence. By conducting appropriate corporate and lien searches, the lender may discover (and can attempt to deal with) new third party issues, such as new registered liens against the borrower, the failure to maintain required corporate filings, new material litigation or even judgments registered as executions.

Logistical Matters

The unprecedented government policies instituted as a result of COVID-19 call for large-scale social distancing and the halt of all non-essential services. These policies create some logistical challenges for lenders, who will need to adapt their practices to adhere to the social distancing measures.

- **Electronic Signatures:** Many lenders require original signatures in their lending transactions. However, with many people working from home, and with social distancing, obtaining signatures, original or electronic, is challenging. Generally, a legal requirement that a document be signed or endorsed is satisfied by an electronic signature that meets information technology standards, as stated in the *Electronic Commerce Act*. Lenders can therefore obtain electronic signatures via electronic document management platforms such as DocuSign, and should consider making provision for this. Some exceptions to the general rule include signatures for wills, trusts and negotiable instruments. As well, the widely used practice of obtaining signatures by printing, executing and then scanning PDF copies of documents can still be used. As a practical matter though, people working from home may not have the necessary equipment to print or scan, so fully electronic methods may be preferable.
- **Originals:** In some circumstances, lenders require the delivery of original documents. Physical delivery may become challenging; it may not be practicable or even possible to obtain delivery of originals as many individuals are working off-site. However, there are creative solutions available. Consider, for example, where one lender is being replaced by another lender and the security package includes a pledge of shares. Possession of share certificates is required to perfect the security interest in certificated securities to ensure first priority. In this case, the existing lender can acknowledge and agree to hold the share certificates as agent, on behalf of the new lender, and undertake to deliver the share certificates as soon as practically possible. These kinds of solutions will be essential in these challenging times where 'normal' closing mechanics are simply not possible.
- **Virtual Commissioning of Affidavits:** Where lenders require the delivery of statutory declarations (for example, as required for real estate security or for perfecting foreign security), they may rely on affidavits commissioned by way of video conference, subject to the lawyer administering the oath being aware of and taking steps to mitigate the risks of doing so. The Law Society of Ontario has announced that, although they do not have the jurisdiction to change the requirements associated with commissioning, they will interpret the applicable requirements set out in the *Commissioners for Taking Affidavits Act* as permitting virtual commissioning. The best practice for commissioning documents

remains for the commissioner to be in the physical presence of the deponent to commission the documents, where possible.

Lenders will face a host of new challenges as a result of the global pandemic. With proactive measures and flexible and adaptive solutions, lenders can face the new economic realities while ensuring that they protect their financial and legal position.

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