IN THE KNOW

Leveraged Finance Newsletter

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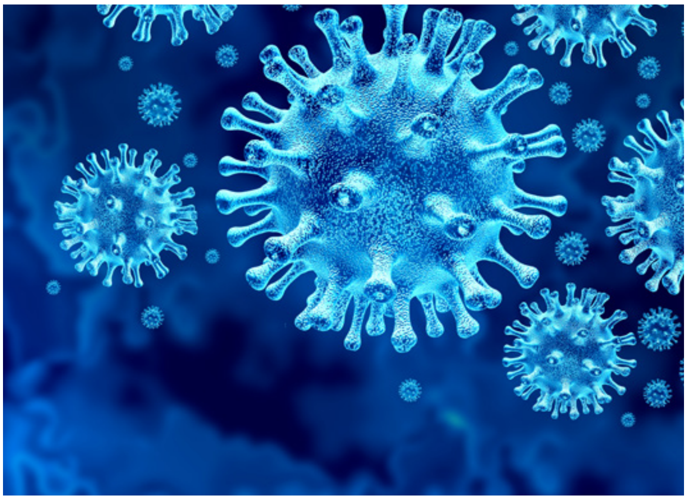
NOVEL CORONAVIRUS OUTBREAK: DON'T OVERLOOK THESE IMPLICATIONS FOR YOUR LEVERAGED FINANCE DOCUMENTATION

The outbreak of the novel coronavirus (Covid-19) is having increasing global impact including loss of lives and growing disruption. Amidst this rapidly changing situation corporates, sponsors, banks and other financial institutions need to be aware of the potential financial, regulatory and legal consequences for their business. In this article we identify certain key risks arising from the Covid-19 outbreak that apply to existing and new leveraged finance structures and which may have been overlooked.[1]

In our article on 26 February, *'The Coronavirus and Force Majeure in Supply Contracts - English Law Perspective'* we considered recent cases of companies seeking to implement *force majeure* clauses in supply and other commercial contracts.[2] English courts have consistently looked to specific *force majeure* provisions the most common of which are not typically included in leveraged finance documentation. The leveraged finance equivalent is the material adverse change event of default which centres on the definition of material adverse effect ("MAE").



The MAE definition is commonly drafted broadly and with some variety for top tier sponsors and corporates. As such, it is necessary to analyse the specific wording on a case by case basis to consider whether the Covid-19 outbreak is relevant. Recently, we have helped clients to consider whether an express carve-out from the MAE definition for Covid-19 is appropriate. However as we have seen when faced with other macro-economic headwinds (most notably the global financial crisis but more recently US/China trade tensions and Brexit) lenders have traditionally looked for more demonstrable matters of fact, such as non-payment, before taking steps to accelerate or enforce on a capital structure. So the importance of the material adverse change event of default as a substitute for *force majeure* in this context may be overstated in practice.

Indeed there may be an increase in the number of payment defaults, especially among borrowers that rely on supply chains or operate in industries that are exposed to the *force majeure* contractual suspensions we discussed previously.

In this article we consider potential (but perhaps less obvious) pitfalls in leveraged finance documentation in the context of Covid-19 in respect of existing capital structures, and in respect of new leveraged acquisitions.

Impact on existing capital structures

Don't forget the springing financial covenant

An established feature of the syndicated leveraged loan market has been the adoption of the High Yield Bond approach to financial covenants. *Cov-Lite* leveraged finance structures whereby all ongoing maintenance financial covenants have been replaced with incurrence financial covenants that are only tested when the borrower takes certain specified steps such as to incur debt or make a prohibited

1 This is a rapidly developing situation which Baker McKenzie is monitoring and further up to date analysis and resources relating to Covid-19 can be found at our **Coronavirus Resource Centre**.

2 Available **here**.

dividend or acquisition dominate the market. In capital structures which include only *Cov-Lite* term loans and/or High Yield Bonds, the covenant package would be incurrence based only (and not include any maintenance covenants). On this basis, although financial difficulties faced by the credit may significantly limit its ability to incur additional debt or make payments outside of the restricted group, no financial covenant event of default would be triggered solely on the basis of the financial deterioration of the credit.

However the revolving working capital facility that typically sits alongside a *Cov-Lite* term loan or a High Yield Bond will contain a maintenance covenant that is tested in the event that the revolving facility is drawn beyond a minimum threshold on the periodic test date (this feature is known as a "springing covenant"). In a financially healthy borrower cashflows can typically be managed so that this testing threshold is not exceeded on a relevant test date. However, as Covid-19 may have an adverse impact on activity levels and supply chains this may result in greater working capital needs and un-forecasted testing of springing covenants. Whether this will result in a breach of the springing covenant will require careful analysis of the borrower's financial statements and the terms of the relevant springing covenant itself.

"Shock" adjustment

In certain credits where leveraged term loans have contained maintenance financial covenants, borrowers have sought to mitigate the impact of an unforeseen or unquantifiable "shock" event via the inclusion of additional cure rights in respect of financial covenant breaches. One example of this is a shock adjustment cure right which entitles the borrower to notify the lenders that a business disruption event has occurred and that, as a result, in the next financial quarter actual earnings for the group should be adjusted or recalculated to mitigate the impact of the "shock" event. The definition of business disruption event will be subject to negotiation but will typically include references to acts of God, natural disasters, epidemics or pandemics.

MAE drawstop

We noted above lenders' hesitancy to accelerate or enforce purely off the back of a MAE event of default. However, in certain circumstances the material adverse change event of default might afford revolving facility creditors the opportunity to refuse to fund new (non-rollover) utilisations of the revolving facility which may have significant consequences for liquidity constrained borrowers.

Impact on new leveraged acquisition financings

Funding conditionality

A lender's financing commitment is generally subject to the satisfaction of certain financing conditions which are contained in the commitment letter. Failure to comply with these conditions gives rise to a "financing out" entitling the lenders to walk away from their financing commitment. It is important for the borrower and the lenders to consider whether the Covid-19 outbreak impacts the conditionality and certainty of the financing commitment under commitment documents.

Unlike in the US market where material adverse change ("MAC") is customary both on the sale and purchase agreement documenting the acquisition terms and on the debt financing, in the European market there is typically no 'MAC financing out'. Parties therefore need to look closely at the termination rights in their commitment letters to ensure that changes in the financial position of the target that occur between signing and closing are treated appropriately to align with the M&A process.

Similarly the obligation of the lenders to fund under a signed but undrawn loan agreement is subject to satisfaction of various documentary and evidential conditions precedent and the making of a suite of representations regarding the transaction by the borrower (and any guarantors) to the lenders. The parties should consider whether the borrower's ability to satisfy these conditions precedent is impacted by the Covid-19 outbreak.

Likewise in purchase agreements and subscription agreements in capital markets transactions, banks should carefully consider potential implications in the contractual termination provisions. Termination provisions generally provide a list of events, typically including epidemics, pandemics and outbreaks of diseases, which give the banks (but not the issuer) a potential termination right. The event would need to be material and adverse and make it impracticable or inadvisable to proceed with the offering, sale or delivery, of the bonds. In reality, the termination provisions only take effect upon signing the agreement (generally at pricing) so the time between signing and closing during which the banks could terminate is limited to a relatively short timeframe. In this light, one solution could be to set the base case as at the date of signing and that only a material deterioration would trigger the termination right (as oppose to signing into an underwriting contract in which the termination provision was already theoretically been triggered). During the Gulf War for example, certain underwriting agreements specified that the termination clause would only be triggered if the conflict escalated.

Syndication disruption

Disruption to the financial markets may have an impact on the ability to syndicate new financing structures. Careful attention will be needed when agreeing what constitutes successful syndication, the trigger for justifying flex and the length of the syndication period. Containment policies advised by relevant health authorities include large-scale remote working. Financial Institutions operating in global markets are also advising against and in some cases refusing to authorise international business travel for staff and in certain jurisdictions closing down offices. Parties therefore need to consider, on the sell-side, how this will impact their ability to market new deals and, on the buy-side, their ability to analyse the investment case in the context of a rapidly changing macro-economic environment.

Covid-19 has forced businesses around the world to adopt new ways of working. One aspect of the capital raising process that has been around for many years is the investor roadshow and face-to-face meetings to help the book building process. Given the travel restrictions put in place by governments and the reluctance of many people to travel, parties may move towards conducting more online net roadshows, and there are already reports of this happening. With the obvious cost saving advantage and efficiency, not to mention the avoidance of long-haul travel and jet-lag, it remains to be seen whether one of the lasting effects of the Covid-19 outbreak could be the widespread adoption of new roadshow practices.

Disclosure

One of the more challenging aspects of the Covid-19 outbreak for bond financings relates to the disclosure of business risk and impact. Disclosure can be broken down into two elements: first, the disclosure requirements of the relevant stock exchange and/or regulator when securities are first offered to the public and second, the ongoing reporting and disclosure obligations once securities have been listed.

A company preparing to list securities will need to prepare an offering document that discloses, among other things, the risks relating to the business. For many years, since the emergence of the severe acute respiratory syndrome (SARS) outbreak in 2002, offering documents have often included a fairly generic risk factor to disclose that the outbreak of an infectious disease could affect the business, financial condition, results of operation and prospects of the company's group. As new diseases have come along, such as Middle Eastern respiratory syndrome (MERS), Ebola, avian flu, H1N1 and the Zika virus, these have been added to the risk factor. We are now seeing references to the Wuhan coronavirus being included.

Companies in certain jurisdictions, including key financial centres, such as those in the European Union, the United States and Hong Kong, will be heavily regulated and disclosure is likely to be subject to greater regulatory scrutiny. For companies listing in these jurisdictions, operating in highly infected jurisdictions or in industries which may be more highly impacted, a general infectious disease risk factor may not be enough to satisfy regulators or investors. In these cases the risk factor will need to provide much greater detail and specificity about how the virus could affect the business. The degree of disclosure will depend on many issuer-specific factors such as the level of information and data available, the significance of operations in more highly infected jurisdictions, the industry it operates in, the effect on supply chains, business continuity planning measures and the geographic proximity to the virus.

Due diligence

Offer documents require the underwriters' due diligence. Underwriters and counsel will need to carefully assess their ability to conduct appropriate due diligence if site visits and in-person meetings become more difficult to arrange due to government travel restrictions or the unavailability of management. We may also start to see Covid-19-specific due diligence questions being asked in management meetings and on bring down and closing calls.

Conclusion

The outbreak of Covid-19 is a rapidly developing situation which is difficult to predict. All parties in leveraged finance documentation need to be aware of the ways in which their capital structure may be affected and consider carefully their options. Please stay up to date with further developments at the Baker McKenzie **Coronavirus Resource Centre**.

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