ASIAN LEGAL BUSINESS

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Coronavirus: Time for Companies to have a Financing Check-up whilst the Black Swan is Circling [Brought to you by Gibson Dunn]

COVID-19 could be the black swan that has devastating effects on the global economy. Concerns over the impact of the virus have caused significant volatility in the stock markets over the last few weeks and the potential scale of the impact across a very wide range of industries is just beginning to be realised.

Now is the time to be checking your financing documents to fully understand how COVID-19 might impact your operations and financial results and your ability to remain in compliance. If you are a borrower in the Asia-Pacific region, this article is particularly relevant to you.

Key areas you should be focusing on include:

FINANCIAL COVENANTS/EQUITY CURE/COVENANT RESET

In most markets in the Asia-Pacific region, loan facilities typically still have two or three maintenance financial covenants. Given the myriad of ways that a public health emergency like COVID-19 can affect businesses, and the scale of the impact, it seems inevitable that the virus will cause some companies to breach these financial covenants. The threshold questions then become which covenants will be breached, when will they be breached and what steps can companies take to address the problem.

Business Interruption Insurance

In determining whether a covenant breach is likely, it is worth first carefully considering whether there is business interruption insurance in place that will cover the losses incurred by a company. Whilst proceeds of business interruption insurance can typically be added to EBITDA for purposes of calculating compliance with the maintenance covenants, whether a particular policy covers business interruption resulting from COVID-19 will be very much fact specific and turn on its specific language. Many property insurance policies cover business interruption, but coverage for such loss often requires "direct physical loss or damage" which in many cases will not apply. Also, to the extent that business interruption insurance coverage is available, the EBITDA definition needs to be carefully reviewed to see whether amounts claimed can be included (more typical) or whether the insurance proceeds have to be actually received by the group in order to be included in EBITDA (which could create a timing issue).

Scrubbing the Definitions - Restructuring Initiatives/Other Add-backs

Upon initially concluding that a covenant breach is projected, you and your counsel should "scrub" the definitions to ensure that all available add-backs, synergies and initiatives, and the pro forma effect of each of them, have been properly included in the calculations. Thought should also be given to commencing certain planned initiatives and actions ahead of schedule to take advantage of the pro forma effect.

Prepayments to Avoid the Breach

In some circumstances, it may be possible to fix a potential covenant breach with a prepayment. For example, a well-timed voluntary prepayment of an amortizing facility made from cash on hand now, could, in addition to reducing leverage, potentially avoid a breach of the debt service coverage ratio in the subsequent three quarters (often with a dollar-for-dollar reduction in debt service). Similarly, where you have flexibility to apply mandatory prepayments first against amortizing debt, we have, in the past, seen companies use proceeds from disposals which have not yet been reinvested (or to specifically dispose of assets) in order to reduce both leverage and debt service.

Additional Pre-emptive Equity

Typically, sponsors and/or a parent company always have the ability to inject additional capital into a borrower's business (by way of equity or subordinated debt) which would reduce net debt regardless of whether a prepayment is made. Nonetheless, this is not the typical approach for companies facing a prospective financial covenant breach unless the amount injected can be subsequently designated as a "cure amount" and there is additional benefit to injecting it earlier (for example, to fix a clean-down issue (as discussed below) or to avoid a mandatory prepayment if that is required under the equity cure).

Companies are then broadly faced with either: (i) using the equity cure; (ii) asking for a waiver; or (iii) negotiating a covenant reset/broader amendment or refinancing.

Equity Cure

In a well-negotiated loan agreement, financial covenant breaches can often be cured within 15-20 business days of the date on which a compliance certificate is required to be delivered. Careful consideration needs to be given to the parameters of the equity cure provisions (which typically, but not always, apply to all of the covenants).

For example, can the cure be used pre-emptively and subsequently be designated as a cure amount? Some companies will opt to provide the equity cure at the same time they deliver the compliance certificate so that they are effectively never in breach. However, others will use the additional 15-20 business day grace period so that they are not utilising funds sooner than is necessary. For those who wait, the next question is whether a default continues during that cure period. If so, for most companies, the issue that arises is whether or not they utilise any of the facilities during this time, as a continuing default would typically be a drawstop (except

for rollover advances) and may affect certain assets which are secured. Therefore, careful planning around this is required.

As a side note, a funding drawstop may be the beginning of a company's downfall, especially if such loans are required to continue trading. It is important to be aware of the triggers for funding drawstops, whether there is any advantage to a premature drawing of a revolving credit line (although this may not necessarily garner favour with the lenders) and how vital any undrawn facilities (particularly working capital facilities) are to the going concern nature of the group. Additionally, companies may wish to extend their interest periods in parallel to potentially accelerating timing of utilisations.

Other key questions to analyse in the context of an equity cure are:

- How is the cure actually implemented? Under many facilities in the Asia-Pacific region, companies are able to add cure amounts to EBITDA which obviously brings with it a multiplier effect, as opposed to being required to use such amount to make an actual prepayment to reduce debt. Similarly, where adding the cure amount to EBITDA is not permitted, under some facility agreements such cash is allowed to be retained in the group (thereby reducing net debt to the extent it remains in the group, rather than being required to be prepaid). Also, where a prepayment of the cure amount is required, the facility agreement may not obligate the company to use 100% of the cure amounts which are required.
- What are the limits on the cure? For example, how many cures are permitted over the life of the facilities (typically 4-5)? Are over-cures permitted (often they are)? Are cures permitted in successive quarters? Where the cure amount is applied to EBITDA, does this carry over for the next three financial quarters (almost always it does)?
- Is there a mulligan? The true "mulligan" – taken from the golfing world – provides that an initial breach of the financial covenants is not a default unless the same test is breached on the subsequent test date. In the Asia-Pacific region, true mulligans are fairly rare. It is common, however, to see a deemed cure which provides that where there is an initial breach, it is deemed to have been remedied if it is in compliance on the subsequent test date and the lenders have not accelerated the loans. In this scenario, where there is a projected single-quarter blip in performance, some companies might look to the lender syndicate to see if they have relationship lenders with blocking stakes (typically 33.34% or more in the Asia-Pacific region) who agree to prevent an acceleration event from occurring, but more often companies in this situation will seek a waiver or a covenant reset.

Covenant Waiver

For a company with a projected one-off financial covenant breach, it may seek a simple waiver of that breach. In the Asia-Pacific region, the waiver will typically require 66 2/3% of the lenders to consent to the waiver and a waiver fee would typically be paid.

Covenant Reset

Where a company is projecting more than a one-off problem with the financial covenants, it is more typical that it would seek to reset the covenants to re-establish sufficient headroom. This approach is obviously a more protracted process than a one-time waiver as the lenders will need to get comfortable with an updated plan and financial model, and often involves a broader negotiation as some lenders may request changes to provisions such as amortization, excess cash flow sweep and pricing. They will also expect an amendment fee. Like a waiver, typically in the Asia-Pacific region 66 2/3% of the lenders would be required to reset the covenants. The company may or may not negotiate the covenant reset in conjunction with an agreement to arrange for an injection of more equity into the group. Obviously, a company and its parent or sponsors are more likely to agree to inject additional equity as part of the covenant reset if there is an underlying, fundamental issue with a company's performance rather than simply being adversely affected by what are hopefully near-term situations such as COVID-19. In the latter case, companies may also proactively consider

a broader "amend and extend" or refinancing of the facilities to fix the covenant issues and address any other issues such as impending maturities or a need for more flexibility in certain areas.

CLEAN-DOWN

Depending on the nature of the company's business, some facilities will have "clean-down" requirements on its revolving facilities. These provisions require cash drawings under the revolving and ancillary facilities to be reduced to an agreed amount (sometimes zero) either physically or net of cash and cash equivalents for a short period of time (typically 1-5 consecutive business days) in a year with a short period of time (say, 1 month) between clean-downs. Clean-downs are designed to demonstrate that the revolving facilities are not being used for permanent debt. Where there is an ability to utilise the revolving facility for permanent debt such as acquisitions, joint ventures or capital expenditures, the drawings of such amounts would necessarily need to be excluded from any clean-down.

COVID-19 is likely to mean that some companies are more reliant on their revolving facilities than usual and may struggle to meet their clean-down obligations. In this type of circumstance, in addition to waivers of the requirement, we have seen companies in the past pre-emptively arrange for the injections of equity into it to fix the clean-down issue and subsequently designate the same proceeds as cure amounts to equity-cure a covenant breach some quarters later.

REPRESENTATIONS AND WARRANTIES

The representations and warranties in a facility agreement serve two primary purposes: (i) to flush out information regarding the group where the consequence of a breach is an Event of Default; and (ii) to serve as a drawstop on new utilisations of the facilities.

A number of typical representations and warranties should be given consideration in the context of COVID-19 (there may also be other deal-specific representations which need to be reviewed). First, the second limb of the "No Default" representation, which is a look-forward to defaults or termination events under other agreements (not the finance documents) and is typically subject to a "Material Adverse Change" qualification. This representation could be relevant where a company's performance under a "material contract" is adversely affected by COVID-19 or a counterparty breaches such a contract. In addition, where a company has contracts which would reach this threshold of materiality, there is often an additional "Material Contracts" representation which should be reviewed.

Secondly, companies must check whether their facility agreement contains a particularly troublesome material adverse change representation which is included in the Loan Market Association's (LMA) leveraged standard form. It provides that "*Since the date of the most recent financial statements delivered pursuant to Clause 25.1 (Financial statements) there has been no material adverse change in the assets, business or financial condition of the Parent or the [Restricted] Group [or the Group].*" This provision is a tripwire and should not be accepted by companies, although it is in a number of facility agreements in the market. This frequently misunderstood representation does not relate to the performance of the business since closing, but rather since the date of the most recent financial statements and, equally importantly, is not the negotiated, defined "Material Adverse Effect" standard but is tied to the looser term "material adverse change." The tripwire here is that the portfolio company could be performing well above both its business plan and financial model but has a temporary but material dip in performance which can result in a performance breach despite the fact that it is in compliance with its covenants.

Thirdly, the "No Proceedings" representations, which relate to litigation and judgments, should be reviewed. Invariably, some companies will be subject to litigation resulting from their failure to perform under their contracts, and it is likely that many parties will assert that COVID-19 is a force majeure event such that noncompliance with their contractual obligations was beyond their control and not actionable as a breach of contract. All of this could result in many businesses becoming tangled in complex and protracted litigation even when they intended to fulfil their obligations.

It is also recommended to look at the "Insolvency" representation. This representation is linked to the insolvency-related events of default and discussed below.

Finally, many companies will be unaware that a number of representations will be repeated automatically (including those buried in side letters or ancillary agreements such as security documents), for example, on each interest payment date. Whilst a number of these representations are often technical or legal in nature, a number also extend to factual scenarios and, in some cases, to a representation that there is no default.

REPORTING OBLIGATIONS

Reporting obligations to lenders vary from facility to facility but, in addition to financial information, typically include matters relating to litigation, judgements and where relevant, material contracts as well as the catchall of whatever else is requested by a finance party. Companies are well advised to discuss early how and when information will be disclosed to lenders, particularly in light of the highly evolving nature of COVID-19 and its potential effect on businesses.

Customary loan documentation will typically require a company to certify that no default is continuing (or, if a default is continuing, to specify the default and steps taken to remedy it) at any time upon a lender's request. This seemingly innocuous provision may be relied upon if a lender becomes aware of potential financial difficulties to procure an acknowledgment that a default has occurred and trigger the protections that arise on a default. Companies should be thoughtful when responding and carefully ascertain whether legally, and on an interpretation of the finance documents, an actual default has occurred.

Loan agreements usually include a general undertaking requiring the company to grant lenders free access to its premises, assets, books and accounts, and to meet and discuss matters with senior management, upon a default. The undertaking often extends to a situation where there is only reasonable suspicion of a default, meaning it may be invoked by lenders ahead of an actual default and result in unnecessary disruption to the company's regular business. Hopefully, this undertaking has been limited to permit entry only during business hours, with advanced notice and is subject to confidentiality.

EVENTS OF DEFAULT

Insolvency/Insolvency Proceedings/Creditors Process

These events of default speak for themselves and are unlikely to be the first breach of the facilities for the group. However, they warrant consideration and attention because amongst other things, the threshold for insolvency varies from jurisdiction to jurisdiction as do the duties of the directors.

It is important that these default triggers do not occur prematurely and distinguish between actual signs of financial distress and mere symptoms of an erratic market.

The Asia Pacific Loan Marketing Association (APLMA) formulation of the "insolvency" event of default comprises of several trigger events, where the materialisation of just one (naturally, the lowest common denominator) sounds the alarm. Of particular concern is the limb crafted as a balance sheet insolvency test, i.e., that assets are less than actual and contingent liabilities. This is usually on an individual-company (rather than consolidated) basis, meaning just one company within the group could trigger a default, even where it is not actually in financial difficulty, can meet its liabilities as they fall due and is not presumed insolvent under local law.

Another troubling limb of the APLMA formulation of "insolvency" event of default touches on the commencement of informal measures (such as negotiations with creditors) in relation to actual or anticipated financial difficulty. An event of default can be triggered by a company "by reason of actual or anticipated financial difficulties, commencing negotiations with one or more of its creditors with a view to rescheduling

any of its indebtedness." On its face, the "rescheduling of any indebtedness" could include a company's discussions with its lenders, landlords or trade creditors, regardless of the debt quantum concerned, which could be perfectly harmless and normal negotiations by any standards. English case law has determined that the term "rescheduling" implies a degree of formality and relates to the formal deferment of debt-service payments and that the lead-in wording of "actual or anticipated financial difficulties" envisages "difficulties" of a substantial nature. It is not, therefore, concerned with an informal telephone conversation with, or email to, a relationship or credit manager requesting "a bit more time to pay." This would be commercially unfeasible, particularly for highly leveraged businesses which might have such conversations on a daily basis. Well-advised companies should have limited the ambit of this event of default from the outset, rather than rely on case-law developments when a dispute arises. Prudent companies should therefore try to exclude negotiations with trade creditors from this event of default, require that negotiations be with a "class" rather than single creditor, or specify that the event of default is triggered only on the occurrence of formal legal proceedings. Given the fact-sensitive nature of this provision, it is also important that companies are alert to the possibility of a default being triggered at the outset of a stressed or soon-to-be distressed scenario and upon commencing informal discussions with a single creditor or class of creditors.

Audit Qualification

Often in facilities in the Asia-Pacific region, an event of default occurs if the auditors qualify their report either on a going concern basis or owing to a failure to disclose information. In the aftermath of the last financial crisis, there was much debate around whether a projected breach of a financial covenant which is noted in the auditors' report amounts to a qualification – thus causing an event of default ahead of any actual breach of covenant. In most cases, the conclusion was that for a simple projected financial covenant default, the auditors do not "qualify" their report but include an "emphasis of matter". The emphasis of matter is a paragraph, which highlights a matter that in the auditor's opinion is of fundamental importance to a reader's understanding of the financial report but which falls short of the technical standard of an auditor qualification. However, although this has been the general conclusion in the case of projected breaches, it should be confirmed on a case-by-case basis with the relevant professionals in the local jurisdiction.

Litigation & Material Judgments

As discussed above, the impact of COVID-19 will inevitably be the cause of some contractual breaches which will result in litigation and judgments and need to be considered here.

Material Adverse Effect

Loan facilities in the Asia-Pacific region often have a catchall Material Adverse Effect event of default. Well-advised companies in a reasonably strong negotiating position should have negotiated the definition of "Material Adverse Effect" aggressively so that it is very limited and does not include the LMA formulation which includes a look-forward on the ability to comply with financial covenants and/other obligations. The reference to "prospects" should have been resisted. The scope of the obligations captured under the definition of "Material Adverse Effect" should also be limited to only significant undertakings such as payment obligations. The impact of obligor parties subject to the definition of "Material Adverse Effect" should always be considered "as a whole" rather than on an individual basis. A distressed or insolvent subsidiary, which is part of a large multi-guarantor obligor group, is unlikely to have much impact to the lenders' position. Another approach would be to limit the "Material Adverse Effect" obligors to only those that are financially material, for instance, subsidiaries with a net asset value of no less than, for example, 5 – 10% of the entire group's net worth. Also, this event of default should be negotiated to be an objective test – rather than the subjective "which the Majority Lenders reasonably believe…." construct of the LMA. However, there are examples in the Asia-Pacific market that follow the LMA formulation.

If this definition and event of default are correctly negotiated, while it may be scrutinised, in the absence of any other "black and white" events of default having occurred (such as a financial covenant breach), most

lenders would be unlikely to rely solely on a Material Adverse Effect event of default in order to take any acceleration actions.

HOW WE CAN HELP

Reviewing facility agreements and conducting an in-depth analysis of the current and future impact of COVID-19 on companies is necessarily a complex task, and there is no one-size-fits-all answer. Each case will need to be examined based on the particular facts and the specific drafting of the finance documents. Gibson Dunn's global finance team is available to answer your questions and assist in evaluating your finance documents to identify any potential issues and work with you on the best strategy to address them.

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