CORPORATE
LIQUIDITY ADVICE

Practical advice for company directors facing a liquidity crunch

Gibson Dunn partners Michael Nicklin, Jamie Thomas, Paul Boltz and Scott Jalowayski run through the main issues and how to approach them

Covid-19 has had a devastating impact on thousands of companies around the globe. Among other challenges, the lockdowns and various restrictions have caused liquidity issues for many and will continue to do so for the foreseeable future. This article discusses some of the critical actions that company directors facing liquidity crises should consider in these unprecedented times.

Director and officer insurance: Directors should first of all review their director and officer insurance policies to understand fully what they cover and what they don't. Liquidity issues can lead to insolvency, and the risk of claims against directors has a tendency to increase dramatically during periods of financial difficulty.

Director duties: Directors should obtain independent legal advice to ensure that they have a comprehensive understanding of their duties. As companies enter the insolvency zone, director duties generally shift from being owed to shareholders to being owed to creditors.

There are a number of additional issues that directors need to be mindful in such circumstances. Examples include fraudulent conveyance or preference transactions, transactions at undervalue, wrongful or fraudulent trading, misfeasance, and in the case of public companies – misleading the market. Special consideration is also recommended for sponsor directors as they may have inherent conflicts in their dual roles.

Independent financial advisors: Directors should contemplate the appointment of an independent financial adviser with significant experience in advising financially-distressed companies. These advisers are often referred to as chief restructuring officers. Experienced independent advisers can often enhance the rigour of fiscal discipline in distressed businesses. They can provide strategic advice around capital structure optimisation and devise turnaround or restructuring plans.

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Cash committee: Creating a committee comprising a small number of directors to scrutinise cash outflows and determine whether and when payments should be made could also be of help.

Communication planning and strategy: A strategy for communicating with financial creditors, suppliers, customers and employees should be developed alongside a plan for its implementation.

Scenario planning: The financial projections used by companies are usually based on a single set of assumptions, but the Covid-19 crisis has created unprecedented uncertainty. In such circumstances, financial projections based on a single scenario are inadequate. Directors should engage in planning for multiple scenarios so that all likely outcomes are reviewed, taking into account multiple factors that are regularly updated.

Understand obligations to financial creditors: Understanding a company's obligations under its financing arrangements is critical. This includes not only debt services and financial covenants – including add-backs and cure rights – but also other obligations and default events as well as any applicable grace periods. Covid-19 will likely have caused a sudden drop in revenue for many, and debt service obligations should be reviewed in the context of up-to-date projections based on realistic assumptions.

Directors should determine whether they require any amendments or waivers from financial creditors and, if so, what voting thresholds are required. Some of the typical requests so far witnessed during the Covid-19 crisis include:

- deferring principal repayment dates;
- extending interest periods;
- adding PIK toggle flexibility;
- freezing margins at the current rate rather than referring to a leverage grid;
- flexibility to utilize excess cash flow that would otherwise need to be prepaid;
- obtaining financial covenant waivers for specific testing periods and adjustments to exclude the impact of Covid-19;
- suspending clean down requirements;
- extending the timeline to provide audited accounts and carve-outs for Covid-19-related audit qualifications for other specific carve-outs or default events.

Where a PIK toggle – the ability to use payment-in-kind rather than cash-pay interest – is an option, directors should exercise it too. Selecting interest periods that are as long as possible also has the benefit of delaying the cash outflow to pay interest. Where revolving facilities are technically required to be repaid and redrawn, this can minimise the number of times where drawdown conditions have to be met. In many loan agreements, certain representations are repeated on interest payment dates. If revolving facilities have to be cleaned down, the best time to do this should be determined in the context of liquidity forecasts. These should be monitored closely until the obligation is met.

For unfunded revolving commitments, directors should consider whether to draw down the facility in full in order to preempt potential drawstop events and future drawdowns. In addition, where incremental facilities and other baskets are available, utilising these can provide additional cash buffers.

Government assistance: Many governments across the globe have offered assistance to struggling businesses, including through loans and guarantees of loans or furlough schemes for employees. These should be examined carefully to determine whether a business is eligible and the potential impact on the business.

Business interruption insurance: Business interruption insurance policies should be considered to assess where a claim can be made. Whether a particular policy covers business interruption resulting from Covid-19 will be very much fact and language-specific. Many property insurance policies cover business interruption, but coverage for related losses often requires direct physical loss or damage, which in many cases will be inapplicable.

Sponsoring management fee deferral: Where portfolio companies are required to pay management fees to their private equity sponsors, sponsor management agreements frequently provide flexibility to defer payment of management fees. This can occur when companies face liquidity issues or risk defaulting. These rights should be exercised where possible.

Renegotiating other obligations: Many companies are already successfully renegotiating leases and contracts in order to reduce or defer payment obligations. Others are also stretching their creditors through informal payment deferrals.

Accelerating collections: Accelerated collections of receivables should be implemented where possible. As discussed above, many companies will be seeking to defer payments at this time, which exacerbates liquidity issues and increases the risk of non-collection due to a debtor's insolvency. Receivables financing can help to mitigate this. In some jurisdictions, carefully drafted pre-payment financing can also be recorded as earnings rather than debt.

Cost-cutting measures: Ascertain what cost-cutting measures can be implemented. Some examples include closing or mothballing facilities, streamlining the supply chain, downsizing to smaller and cheaper premises, eliminating non-essential capital expenditure, reducing general and administrative expenses, and utilising government financial support to reduce employee costs and mitigate or prevent layoffs. Such actions should be implemented expeditiously.

Disposal of non-core businesses and assets: Directors should determine whether any businesses or assets they own are non-core and can be disposed of. If that's the case, a sales process should be actioned and the feasibility of sale or leaseback transactions considered.

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