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The impact of COVID-19 on MAC clauses and lending transactions: A borrower's perspective

In our first post, we discussed the impact of invoking a MAC clause from a lender's perspective. Here, we will examine this impact from a borrower's point of view.

1. How could a borrower defend a MAC assertion in the COVID-19 context?

A borrower's defense to a MAC assertion will turn on the facts of the transaction and the impact the crisis has had on its business. Fortunately for the borrower, the lender, as the party seeking to invoke the MAC clause, will have the initial burden to prove a MAC. The borrower should be prepared to show that: (1) there had been no material adverse change to its businesses, operations, properties, prospects, or financial condition; (2) where there has been a change in its business, such change has not had the durationally significant impact required by MAC case law (except in a situation where the proposed agreement anticipated short-term improvement); and (3) no new information has become available that was inconsistent with information known and disclosed at the time of the commitment letter. This last point will strengthen an argument that the change in the financial health of the borrower or loan parties, if any, could have been foreseen at the time of the commitment. This foreseeability issue is likely to tilt in favor of the lender unless the commitment was made after the WHO declared COVID-19 a global pandemic.

Outside the MAC context, a lender may be able to pursue remedial action where, due to the COVID-19, the borrower is unable to meet its debt service obligation at some time in the future. The borrower will be well advised to demonstrate that it has not breached any of its obligations, or representations and warranties. Where breach is unavoidable, the borrower should stay in communication with its lenders, giving a clear indication of what it will do and the options it is pursuing to avoid being in breach of its obligations. This may include pursuing available government relief programs and seeking covenant holidays. The borrower should also proactively get its books in order, anticipating any requests for assurances of financial health.

2. What is the measure of damages a borrower can claim against a lender who wrongfully invokes a MAC Clause?

Where a lender unsuccessfully invokes a MAC (or the borrower successfully defends against it), the Lender may be subject to damages. There are two potential measures of damages that a borrower may assert and be entitled to if a lender is found to have breached its commitment to lend money:

- One is the difference in value between the contract interest rate and the rate available at the time of the breach;
- The other measure, which is the measure generally followed, is that the breaching party is liable for any damages that were foreseeable to it at the time the parties entered into the contract.

The lender may find itself in a slightly better situation if the lending document contains a waiver of damages. However, such waivers of damages may not be enforceable in all jurisdictions. Lenders should review the governing law of their documentation to determine if an applicable waiver will be enforceable in the context of invoking a MAC clause.

3. Broadly speaking, what concerns should the COVID-19 raise for a prudent borrower?

Representation and warranties

There may be instances in which a borrower is required to bring down its representations and warranties, for example, in connection with accessing revolving lines of credit and incremental financing. Representations that may be impacted here include those relating to solvency, material contracts, or "no proceedings." A borrower should review the language of its representations to ensure veracity and accurate time scope, and that they cover changes in its business prospects. For instance, the representation relating to solvency should be reviewed to ensure that it is limited to historical solvency.

Covenants

Many borrowers have financial covenants applicable only to their revolving credit facilities that are triggered when the facility is drawn in excess of certain thresholds, typically 30-40%. Certain items such as undrawn letters of credit are often excluded, subject to a cap. Borrowers should familiarize themselves with these covenants, to have a grasp of what the levels are, when each covenant is tested, updated compliance projections, etc.

Information undertakings

These vary from agreement to agreement but typically include changes in credit rating, financial information, auditors reports, etc. Borrowers should review their obligation to provide notices under their debt documents and any deadlines by which they are obliged to deliver any such information and notices. Even where a grace period applies, a notice may still be required.

Assets

A prolonged COVID-19 impact on supply, manufacturing and revenue of businesses could negatively impact the available "borrowing base" of businesses reliant on asset based liquidity facilities as the value of such businesses' inventory and receivables decline. In addition, as excess availability under these facilities declines, borrowers may be faced with increased reporting obligations, more stringent limitations on their cash management and required compliance with the additional financial covenants.

Concerns regarding liquidity

Many corporate borrowers have been upsizing revolvers and are drawing down under existing revolvers to ensure liquidity. These borrowers need to weigh additional costs of borrowing against market risks and risks that may affect the particular borrower differently from the overall market because of its industry or particular situation.

Regulatory requirements

Borrowers should be mindful of regulatory requirements. For instance, SEC registrants should consider whether a material borrowing under their revolving credit facility triggers a Form 8-K disclosure obligation under Item 2.03 (Creation of a Direct Financial Obligation).

Pending real estate financing

Many commercial real estate financings today are based on non-binding term sheets as opposed to commitment letters. This poses a risk that the lender could walk away prior to closing if the financial markets remain unstable. Even where a binding commitment letter has been signed, it should be reviewed to determine whether, and in what circumstances the lender can elect not to close.

4. How will COVID-19 impact new debt or refinancing?

Borrowers approaching a financing or refinancing should prepare for a more cautious or restrictive lending environment. Lenders and borrowers exploring or negotiating new debt arrangements should maintain a close focus on the key provisions and considerations highlighted above. In addition to the effects on forecasts and financial underwriting, parties should consider the following risk mitigants that may be beneficial or raised by a counterparty in negotiations: increased due diligence and stress testing by lenders related to borrowers' exposure to COVID-19; higher margins or rate floors, and less room for financial covenant-based step-downs in the near term; other conditions added to and more significant flex in commitment papers; additional short to mid-term headroom under financial covenants, or the ability to stipulate results from a different period for a testing period that has been significantly impacted in an adverse way; and COVID-19-specific add-backs to EBITDA (and lender resistance to robust add-back packages).

Even as most of the global economy and financial markets are experiencing headwinds, certain industries are enjoying a boom. Examples of these are the food and agriculture, healthcare and technology industries. Borrowers in these industries may experience increased willingness from lenders to meet their existing commitments and in some cases, make new ones. Such companies need to ensure that the terms of new deals are as favorable as possible, in the event that the tailwinds subside.

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