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Debt Covenant Compliance and the COVID-19 Pandemic

As the scope and potential impact of the COVID-19 pandemic became apparent over the past week, corporate borrowers rightly focused first on shoring up their cash position. For many borrowers, attention must next turn to their ability to comply with covenants in their existing debt arrangements and other commercial contracts.

We recommend companies take the following steps:

- **Revise the Model.** Analyze the expected impact of the current crisis on cash flows, income statement items and leverage, and revise business models to reflect new base case and downside scenarios. In order to assess whether covenant relief is needed and, if it is, what form that relief should take, the borrower must have as clear a picture as possible of its own financial situation. Recognizing the serious challenges in making any predictions at this moment, continual updates to the model are advisable to reflect the evolving situation.

- **Think Broadly.** Consider not only the ability to satisfy financial maintenance covenants but also whether other elements of the revised business plan, including the company's anticipated incremental liquidity needs, may require the borrower to take action (such as incurring new debt and liens or selling assets) that would violate operating covenants.

- **Identify Domino Effects.** Understand whether a default in one tranche of debt will trigger "cross defaults" in others, including derivative instruments and foreign lines of credit. Evaluate when prospective defaults are likely to occur and consider whether the timing of covenant relief — that is, whether amending the covenant *before* the default is triggered, rather than obtaining a waiver of a default *after* it occurs — could avoid "cross defaults."

- **Formulate the Ask.** Decide on the form and duration of any required covenant relief. Depending on the severity of the borrower's situation (including whether the pandemic's impact on the borrower's business is likely to quickly abate when the crisis does, or persist long afterward), some may only require targeted relief — *e.g.*, a short-term covenant "holiday" or adjustment to financial covenant levels — while others may require a more thorough renegotiation of their covenant package (likely at a steeper cost). Another option in the face of uncertainty: obtain the relief needed in the short-term and reassess later if the crisis or its effects fail to subside.

- **Be Creative with the Give.** Craft a thoughtful "give." The right consideration package for covenant relief is almost always bespoke and can mix purely economic terms (such as rate increases and consent fees) with other concessions that do not reduce cash on hand but provide real benefits to lenders. Depending on the situation, borrowers may offer new guarantees or additional collateral, new or updated covenants (including restrictions on dividends and investments), call protection, stricter draw conditions under working capital lines or increased information rights for lenders. But it is important to think a step ahead: Collateral given exclusively to one lender today is collateral that *cannot* be given to another lender tomorrow.

- **Evaluate Lender Dynamics.** Know the lender group and recognize the sometimes-divergent goals of different creditor constituencies: revolving lenders may want to limit future exposure; term lenders and noteholders may want to preserve value; junior creditors may be more or less forgiving, depending on their view of the credit at the time; and creditors with positions across the capital structure may have interests that conflict with others in the same tranche. Understand whose consent is required, and craft a plan to obtain it.

- **Develop Communication Strategy.** Answer hard questions from lenders honestly and provide crisp supporting materials where appropriate in order to facilitate lenders' decision-making. Keep lines of communication open and foster constructive dialogue, particularly with key relationship lenders, but be mindful of "debt default activists" and other lurking opportunists. Carefully consider any related communications to investors and the public.

Though obtaining debt covenant relief is not often pleasant, advance planning, thorough analysis and effective communication can clear the path to a smoother and quicker resolution.

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