

FUNDING INTO A PANDEMIC: CREDIT AGREEMENTS AND INTERPRETING THE “MATERIAL ADVERSE EFFECT” OF THE COVID-19 CRISIS

As the financial impact of the COVID-19 pandemic is felt by the global economy, businesses and capital providers are taking a close look at their credit agreements to ascertain what implications the crisis may have on compliance and their ability to access (or limit access to) additional funds in the near to medium term. Specifically, Borrowers and their Lenders must closely review funding conditions and representations relating to solvency, pro forma covenant compliance, and material adverse effect to determine whether the impact of COVID-19 constitutes a Material Adverse Effect/Material Adverse Change (“MAE”) or presents other obstacles to accessing funds under their existing debt instruments, with a focus on (i) the exact wording of the MAE definition; (ii) whether the MAE includes prospective language; (iii) the foreseeability of the event; and (iv) duration and significance of impact.

MAE FRAMEWORK

The below provides a basic framework of the usage of MAE concepts in credit agreements:

- The absence of an MAE as a condition to drawing under a revolving credit agreement, which is typically addressed in a bringdown representation/warranty but may also be an explicit funding condition (for both initial advance and ongoing borrowings);
- As an affirmative covenant to provide notice to the Agent of an MAE; and
- In some instances, particularly in the middle market context, as an Event of Default immediately triggered upon the occurrence of an MAE.

While often negotiated, illustrative sample provisions are provided below:

Sample Material Adverse Change definition:

“Material Adverse Change” means (a) a material adverse change in, or material adverse effect on, (i) Borrower’s consolidated financial condition, (ii) Borrower’s consolidated business, assets, properties, liabilities (actual or contingent), operations, condition (financial or otherwise), or prospects, considered as a whole, or (iii) Borrower’s ability to timely pay the Obligations or any Restricted Person’s ability to perform its obligations under any Loan Document to which it is a party; (b) a material impairment of the rights and remedies of Administrative Agent or any Lender under any Loan Document; or (c) a material adverse effect upon the legality, validity, binding effect, or enforceability against Borrower or any Guarantor of any Loan Document to which it is a party.

Sample Drawing Condition:

At the time of and immediately after giving effect to such borrowing or the issuance, amendment, renewal, or extension of such Letter of Credit, as applicable, no event, development, or condition that ***has or could be expected to have*** a Material Adverse Change shall have occurred and be continuing.

Sample MAE Notice Requirement:

Borrower will promptly, and in no event later than the 3rd business day after becoming aware thereof, notify Administrative Agent in writing (for delivery to each Lender) of the occurrence of any other development that results in, or could reasonably be expected to result in, a Material Adverse Change.

INTERPRETING MAE

MAE analysis is fact-specific, focusing on two primary considerations.

1. The exact wording of the definition; and
2. The specific facts at issue for the Borrower, including:
 - (a) Foreseeability of event;
 - (b) Duration of impact to Borrower; and
 - (c) Significance of financial impact.

Although a worldwide pandemic may in some cases be classified as an MAE, it is not customary for credit agreements to contain a “**Market MAC**” (a change in the market generally). The parties must analyze the specific circumstances and direct impact on the Borrower’s financial condition.

Case law does not provide a formulaic approach or bright-line rule to guide interpretation of these provisions. The exact wording of the definition may vary, but a key component of the definition is whether the term includes **prospective/forward-looking events** (*i.e.*, “prospects,” “expected to occur,” or “reasonably expected to occur”) or only **retrospective changes** (*i.e.*, “has occurred”). A forward-looking definition provides a stronger basis for Lenders to claim an MAE prior to delivery of financial statements reflecting such impact. Impact on earnings should also reflect possible governmental programs or other relief the Borrower may be seeking (for further information on the CARES Act, see Thompson & Knight Client Alerts linked [here](#) and [here](#)). Courts have also generally ruled that the duration of impact must be “significant” and not a short-term downturn. Obviously, the potential duration of COVID-19 impacts on Borrowers’ businesses remains unclear at this time and will likely be industry-specific. In addition, the start or “anchor” date must also be analyzed: many facilities incorporate a rolling date from which MAE is measured that is tied to annual audited financial report dates; others relate back to the closing date of the facility; yet others specify a specific test date that may be tied to a specific event (such as a material acquisition or amendment).

CONSIDERATIONS

In certain circumstances, particularly where the MAE definition includes prospective language, Borrowers may benefit from notifying their Lenders of the potential material adverse effect on their specific operations and negotiating a satisfactory resolution (amendment of debt documents, payment, or covenant testing holiday, etc.) before the full effects of the event are reflected in their financial statements. Similarly, Lenders may also benefit from such dialogue before the event adversely impacts covenant compliance.

Although a distressed Borrower may certify as to the satisfaction of all drawing conditions in its borrowing request, including the absence of an MAE, the request, on its face, does not establish such absence or *require* the banks to fund the request. Lenders will conduct their own credit analysis to determine whether the Borrower has met all conditions to funding. Agents also separately review the financial condition of the Borrower to ascertain whether an MAE exists, but typically such analysis is not shared with Lenders. Notwithstanding the tremendous impact COVID-19 is having on the domestic and global economy, Lenders should proceed carefully in analyzing these provisions and relying on an MAE in declining to fund a requested borrowing, especially in a syndicated credit facility where other Lenders have reached a contrary conclusion and are funding such request.

DEFENSIVE DRAWS

During past economic or industry downturns (such as the decline in oil and gas commodity prices in the 2014-2016 time period), many financial institutions implemented “**anti-cash hoarding provisions**,” which require a Borrower to certify, at the time of borrowing, that it would not have an amount on its balance sheet in excess of a certain threshold. These restrictions protected against “defensive draws” often made by a Borrower on the eve of a bankruptcy filing (see, e.g., March 27, 2020 draw by Whiting Petroleum Corp. prior to April 1, 2020 Chapter 11 filing).

As the economy/industry rebounds, Borrowers typically are successful in negotiating such restrictions out of their credit facilities, and currently most credit facilities do not contain such restrictions. Unable to block “defensive draws,” capital providers are reluctant to fund into distressed situations as Borrowers and their equity sponsors consider protective draws to increase near term liquidity. As a result, in addition to MAE provisions, Lenders are also closely examining the other funding conditions (such as solvency representations and pro forma covenant compliance) to determine if other grounds may exist for declining a funding request.

CONCLUSION

Many, including the federal government, are taking action to help reduce the pain of the pandemic. While we “work together” by staying apart, there are many issues to balance – mitigating losses while preserving relationships. In reviewing MAE funding conditions and analyzing their applicability to the present situation, Lenders and Borrowers should proceed carefully with a close eye to the specific language and circumstances surrounding the individual Borrower and its unique business. Lastly, Lenders and Borrowers should note that the absence of an MAE is not the only condition to

funding, and other financial-based covenants, including solvency representations and pro forma covenant compliance, may also require review and analysis.

WE ARE AVAILABLE TO HELP

If you have any questions about the information contained in this Client Alert, please contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below.

CONTACTS:

Andrew P. Flint

713.217.2844

Andrew.Flint@tklaw.com

Sarah H. Frazier

713.217.2875

Sarah.Frazier@tklaw.com

James McKellar

214.969.1605

James.McKellar@tklaw.com

Cassandra G. Mott

713.951.5803

Cassandra.Mott@tklaw.com

Kurt Summers

214.969.1669

Kurt.Summers@tklaw.com

Shad E. Sumrow

214.969.1552

Shad.Sumrow@tklaw.com

This Client Alert is sent for the information of our clients and friends. It is not intended as legal advice or an opinion on specific circumstances. Furthermore, due to the rapidly evolving nature of the COVID-19 pandemic, you should consult with counsel for the latest developments and updated guidance.

©2020 Thompson & Knight LLP