SQUIRE PATTON BOGGS

COVID-19 – Keeping Capital Working

Staying Away From the Edge

In this article, we focus on working capital and consider ways a business can seek to weather the storm and preserve all-important liquidity through this challenging period.

Practical Tips

Given the unprecedented challenges presented by COVID-19 globally, what can senior management do in order to manage and mitigate the risk to the company's financial health?

- Ensure they know and understand what insolvency means in the relevant jurisdiction
- Engage professional advisers, understand and take advice from their advisors about their legal duties, key finance arrangements and key decisions
- Hold regular (virtual) meetings to consider the impact of COVID-19 measures on the financial position of the business
- Prepare short-term cash flow forecasts and review these regularly. Think about flexing these for sensitivities such as the length of a "lockdown" in your jurisdiction/disruption to supply chain/Illiquidity of your customers/loss of significant numbers of your workforce to the virus in a short period of time etc
- Engage with banks, other lenders and shareholders – implement a structured regular communications schedule to brief primary financial stakeholders to reinforce trust and avoid surprises
- Consider whether the financial support that governments are offering is available to the business – liaise with key lenders on this
- Prepare contingency plans to deal with current and proposed restrictions on the movement of people and goods
- Protect and prioritize key suppliers
- Do not neglect internal compliance reporting – avoid unnecessary breaches and consequential challenges in relationships with lenders
- Minute key decisions and the reasons for those
- Communicate with your people/customers/suppliers

Where Is the Edge?

Through any difficult trading period and times of economic distress, it is vital that senior management consider the possibility that at some point the business could be in financial distress. In some cases, it may have to be restructured, if it is insolvent or likely to become so. It is, therefore, important for senior management to understand what the relevant test is for insolvency in the jurisdiction where the company is situated.

Largely, whether the company is insolvent turns on the company's ability to pay its debts as they fall due and/or whether, on a balance sheet basis, its liabilities exceed its assets. However, the test differs between jurisdictions and understanding where "the edge" is will help inform decisions about what advice and steps to take during a difficult economic period. In the UK, for example, the insolvency of a company is determined by reference to s123 of the Insolvency Act 1986. In Germany, the relevant test is set out in sections 17,18,19 of the German Insolvency Code and in the US, a "balance sheet" or "equitable insolvency" test applies.

Understanding when a company is insolvent and also what the obligations of senior management are to the company and its creditors prior to that point (which also differ by jurisdiction) is, therefore, key to ensuring that the right decisions are made in relation to the company's financial position and continued trading. In most jurisdictions (although not in the US) the insolvency laws recognize the concept of trading while insolvent, which could leave senior management exposed to personal liability if the company continues to trade while insolvent.

Different jurisdictions also have different restructuring tools. Some are more flexible than others and some offer the benefit of a "breathing space" enabling the company time to restructure without creditor pressure. In cases where a company operates cross-border, there might be opportunity to choose the best place to restructure.

Managing Costs

Businesses will face liquidity challenges as their revenues are hit and they struggle to manage costs. It is inevitable that stresses on finances will result in many businesses defaulting under their financing arrangements.

So what can businesses do to keep safe as they look across their customary sources of working capital?

Creditors

Businesses will want to ensure that their credit lines are not just sufficient, but also assured.

Finance agreements will typically include a range of default triggers. Typically, a default will have a range of consequences. The main one being that a lender is no longer obliged to lend, and may demand repayment of monies it has advanced.

Businesses should maintain an honest and open dialogue with their lenders throughout this period, working with them to agree forbearance and adjustments where possible. Cooperating in the search for constructive solutions provides the best chance of avoiding surprises and maintaining credit lines.

Businesses should take advice early and review the terms of their finance agreements, in light of the prevailing situation. Every business will have different sensitivities, but it's worth noting some of the defaults that are most commonly considered when a business's financial position deteriorates:

Material Adverse Change

A material adverse change default (MAC) is commonly seen in agreements. Typically, such a clause will provide that a MAC will occur where there is a materially adverse change affecting a range of aspects of the borrower group, its operations, property, condition (financial or otherwise) and its ability to perform its obligations under the finance agreement.

Lenders are generally reluctant to rely on a MAC as the basis for withdrawing support. The drafting of such clauses necessarily lacks precision and the English courts and US courts have given little guidance on these clauses, let alone in circumstances resulting from a universal event such as the COVID-19 pandemic.

Whether or not COVID-19 causes a MAC for a particular business will, therefore, depend on a range of factors: the wording of the relevant contractual term, and the law that governs it, but also on that business's particular characteristics, notably whether it is in a sector (e.g. travel or automotive), which is particularly exposed to disruption as a result of the pandemic. For an event to be material, it is generally accepted that it must not be temporary and must significantly affect a party's ability to perform its obligations.

Financial Covenant Breach

As a result of COVID-19, a business may experience a material deterioration in EBITDA or other measures of financial performance, affecting compliance with any maintenance financial covenants included in its finance agreements.

Prior to the end of the relevant testing period, it is difficult for lenders to declare a default as a result of a financial covenant breach. Even if a business is tracking well behind the relevant ratio, until the relevant financial testing period has completed, there is always the theoretical, if not realistic, possibility that performance may improve unexpectedly. Beyond that point, lenders will want relevant financial reporting data to substantiate any assertion of a default.

If a particular financing agreement provides financial covenant cure provisions (typically in the form of equity contributions), businesses should consider whether investors would be willing to make such further contributions and, if so, what the contractual restrictions are on such contributions.

Cross-default

These provisions can be drafted very widely. The challenge they present is that by their very nature, they necessitate a comprehensive view of all relevant financing arrangements to which the business is subject. A large international business may have a complex group structure with different group companies party to individual financing arrangements across a wide spectrum of financial products. Some of those arrangements may themselves contain cross-default provisions that will also need to be taken into account in negotiations. Businesses should check their swap agreements carefully in this exercise.

Insolvency and Insolvency Proceedings

The scope of typical default provisions in this area can be wide and will intervene well before actual insolvency. For example, standard UK Loan Market Association wording provides that a default could be triggered by any "..step .. being taken in relation to …a[n]…arrangement with any creditor of any member of the [borrower] group..," or by a borrower commencing "negotiations with [any of] its creditors with a view to rescheduling any of its indebtedness." Similarly, the US Loan Syndications and Trading Association wording provides that a default could be triggered by a borrower taking "any action for the purpose of effecting" insolvency or bankruptcy.

Some finance agreements will also include a default based on a balance sheet insolvency test, which may go beyond the relevant statutory (liquidity-based) test.

Consequences of Default

Lenders are likely to condition their forbearance, consent or waiver in relation to an actual or pending default with a request for further information about the financial health and performance of the business.

The occurrence of a default will trigger many consequences in a typical finance agreement, all intervening well before a lender may decide to accelerate outstanding advances under the facilities.

A default will likely constitute a drawstop, entitling a lender to refuse to make any further advances, including those to replace existing revolving loans. Failure to anticipate such a risk may present a sudden threat to the business's solvency.

In general, a business should expect the terms of its finance agreements to provide for an automatic tightening upon the occurrence of a default. For example, certain permissions, notably around the leakage of value from the business away from the creditors, will be suspended and the benefit of favorable rates within a margin ratchet would be lost.

Stock-in-trade and Receivables – Asset-based Lending

Consideration by businesses as to whether they can leverage the assets held on their balance sheets in order to raise working capital, may constitute a good alternative option by which a company can inject valuable liquidity while the peak of the pandemic's effect endures. Lenders may find it easier to structure loans based on the value of a company's, inventory, plant and machinery, property and receivables, rather than against the future cash flow of a business, which is inevitably uncertain at this time.

In addition, the involvement of key customers of the business in any discussions with lenders to restructure debt, is worth considering as global supply chains are being severely disrupted by COVID-19. Certain sectors that are heavily dependent on the continued existence of the supply chain and "just-in time" delivery, for example, the automotive sector, are likely to be adversely impacted by any failures in the supply chain and will be looking to protect their supply chains where possible. We note that such customers are often willing to structure mutually beneficial arrangements, whereby orders can be delivered in exchange for security over receivables/other assets.

A supplier financing facility may help to shore up supply chains by ensuring valuable suppliers are paid on time remain loyal where supplies may be short. Prioritizing valuable suppliers with favorable payment terms should be considered.

Such liquidity may help reassure important credit insurers as they see working capital maintained and suppliers paid on time.

Managing the price of supplies may be complex in the prevailing environment. For example, airlines will need to keep fuel price hedging contracts under careful scrutiny as the oil price drops.

Cash

Careful and conservative treasury management will be at a premium through this period. There are already plenty of examples of businesses drawing their revolving facilities in anticipation of challenges ahead.

Businesses should remind themselves of any restrictions in their finance agreements around the movement of cash, ensuring, for example, that they can pool cash close to costs to minimize the risk of cash traps that may threaten liquidity.

Under those agreements and account terms, banks may have, or accrue upon, a default, for example, the right to set off monies in certain circumstances.

Currency hedging agreements and exchange rate management should be kept under review, as the developing economic situation, with interest rate cuts, brings increased volatility to the currency markets.

COVID-19 will be a concern for just about any business, regardless of the sector or region within it operates. The key to managing working capital through this period will be understanding the legal and contractual parameters within which the business is operating, careful planning and maintaining an open dialogue with key stakehold

Keeping You Up to Date

Please visit the Squire Patton Boggs Coronavirus Resource Hub, brought to you by a global multi-disciplinary team, who will keep you up-to-date about the latest legal, commercial and regulatory developments and where you can subscribe to receive detailed insights to help you navigate the current health crisis. If you need urgent business support with anything Coronavirus (COVID-19)-related, please contact coronavirusinfo@squirepb.com.

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