COVID-19 RESOURCE CENTER

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As a lender, can I refuse to fund?

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Many lenders currently find themselves in a conundrum. They face the prospect of funding loans to a rapidly increasing number of distressed borrowers. Lenders have doubts that many of these loans will be repaid as scheduled, and in some cases don't expect any repayment at all. However, lenders who fail to fulfill their funding commitments would be in breach of their loan agreements, absent certain conditions that would allow them to terminate or suspend their obligations to fund.

So, what are those conditions?

Loan agreements usually require the borrower to bring down all its representations and warranties on each borrowing date. These representations and warranties often include the borrower's solvency after giving effect to that borrowing. A typical solvency definition includes prongs asserting that: the fair value of the borrower's property is greater than its debts and liabilities, the present fair saleable value of the borrower's property is greater than the amount necessary to pay the probable liability of its debts and liabilities, the borrower is not engaged in business for which its property would constitute unreasonably small capital, and the borrower is able to pay its debts and liabilities as they become due. Not surprisingly, borrowers may not be able to accurately make this representation in the current environment. Lenders thus should examine how the solvency definition and representation are worded in the relevant financing agreement. Because solvency requirements are based on an assessment of the borrower's present condition, which would incorporate a circumstance even as unforeseeable as Covid-19, borrowers may not be able to bring down their representations and warranties.

If a Default has occurred or would result from the borrowing under current conditions, in most cases lenders also would not have to fund. Covenants and Defaults tend to vary from deal to deal and may differ substantially depending on the size and profile of the borrower, industry sector, geographic markets and other factors. These provisions often include (i) failure of the borrower to maintain and operate its business in substantially the same manner as on the date it signed the financing agreement and (ii) failure to comply with financial covenants tied to the earnings, cash-flow and other historical performance metrics. Note that a Default is not identical to an Event of Default, as non-payment defaults often include a cure period during which the borrower can remedy the Default. However, in most cases, a Default will suspend a lender's obligation to fund, while an Event of Default is typically required before a lender can add a default rate to the interest margin or accelerate its loan.

One additional possibility to consider, which has been a hot topic recently, is whether Covid-19 consequences constitute a material adverse change (MAC) to, or has a material adverse effect (MAE) on, the borrower and its business. This question has been debated by many legal and financial observers given the extraordinary nature of Covid-19 and its attendant impact on the global economy, particularly on certain sectors such as travel and leisure, energy and retail. Although very rarely invoked by lenders, even during past crises such as the burst of the dotcom bubble, the 9/11 attacks and the 2008 financial crisis, MAC/MAE provisions may enable lenders to cut the cord on funding or gain leverage in workout discussions with borrowers.

Many loan agreements either include a “no MAC” representation and warranty that must be brought down in connection with any draw or a specific “no MAC” condition to borrowing. When the occurrence of a MAC or MAE has been litigated, the inquiries have been intensely fact-specific. The duration and severity of the downturn, circumstances faced by other business in the same industry, actual versus potential harm suffered by the debtor, and other factors are relevant. Nevertheless, courts in New York and Delaware usually have sided with borrowers, and at minimum a challenging lender must be willing to endure costly and lengthy litigation.

Each lender engaged with a desperate borrower seeking to draw down maximum liquidity faces complex choices, not only how to deny funding but whether it is wise to pursue such an approach at all. These scenarios are not amenable to easy answers now, and they likely will become increasingly vexing in the coming weeks and months.