Schulte Roth & Zabel

Alert

Receivable Financing: COVID-19 Related Issues

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The recent worldwide outbreak of COVID-19 has resulted in extraordinary actions, which are currently disrupting economic activity in the United States and globally. As COVID-19 continues to paralyze the economies around the globe, various measures have been taken by the U.S. government to jump-start the economy. However, those measures may be insufficient to stop the recession or the immediate impact on consumer and commercial obligors in finance transactions. Mortgage and asset-backed securities as well as receivables financing transactions are beginning to feel the effects of social distancing and reduced consumer activity. If the efforts to contain the spread of COVID-19 remain ineffectual, the resulting implications for financings secured by such receivables may be severe. Lenders need to consider their options carefully, balancing asset-specific credit risk mitigation with possible liability.

COVID-19 responses, with mandatory closures and "social distancing," presents particular challenges for consumers and as a result may negatively impact financial sectors that rely on consumer activity. Lenders should focus on asset-specific challenges when evaluating their current credit risks, such as:

1. *Hospitality and Tourism*. The hospitality sector may be impacted far beyond the containment of the virus. As unemployment keeps growing and travel bans are in effect in most countries, this sector, which includes timeshare developers and resort owners, may feel the effects of the market disruption long after the virus is contained to the extent consumers continue to feel uncomfortable traveling. Hospitality industry experts believe it could take 24 months or longer before rates and occupancy levels return.[1] Data from hospitality tracking firm STR showed that compared to 2019 figures, hotel occupancy is down as much as 96% in Italy, 68% in China, 67% in the United Kingdom, 59% in the United States and 48% in Singapore.[2] Around the globe, RevPAR — revenue per available room — is down sharply, in fact much more than the industry experienced after the Sept. 11 terror attacks and after the financial crisis of 2008/2009.[3] Based on current occupancy estimates for the immediate future and historical employment impact rates, 1 million direct jobs, or nearly 3.9 million total jobs, have either been eliminated or will be eliminated in the next few weeks.[4]
2. *Auto-Loans and Small Business Loans*. The auto asset-backed securities ("ABS") sector is also at risk to be impaired as a result of the market disruption created by the COVID-19 pandemic. Lenders have attempted to alleviate pressures on the underlying borrowers by providing

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[1] *See* "Devastated Hotel Industry Could Take Years to Recover from COVID-19 Pandemic," *Crain's New York Business*, March 16, 2020, here.

[2] Full article "Data Shows Severe Impact of Coronavirus on Global Hospitality Industry," *PhocusWire*, March 26, 2020, available here.

[3] *Id.*

[4] Full article"COVID-19's Impact on the Hotel Industry," *AHLA*, March 25, 2020, available here.

payment extensions. As part of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"),[5] the federal government allocated $2 trillion in an effort to mitigate the economic fallout from the COVID-19 pandemic,[6] including $367 billion in the form of loans for small businesses impacted by the pandemic[7]; some of those loans could be forgiven. Despite these measures, consumers may still find it challenging to stay current on their loan payments.

3. *Student Loans*. Even before the global pandemic, student loan asset-backed securities had the highest volume of 90-plus day delinquencies among all household debt.[8] With the unemployment rate dramatically increasing, it is certain that more borrowers will default. President Trump and the Department of Education announced it will stop collection proceedings against borrowers who have defaulted on their federal student loans for a minimum period of 60 days, beginning March 13, 2020.[9] However, the plan does not cover private student loans, which amount to over $100 billion. The CARES Act will also provide financial assistance to households below a certain income threshold. The Federal Reserve is supporting lending to households and consumers through the term asset-backed securities loan facility by lending to holders of asset-backed securities collaterized by new loans. These loans include student loans, auto loans, credit card loans and loans guaranteed by the SBA. However, these measures may prove to be insufficient to combat the effects of the market disruption.[10]
4. *Equipment Finance*. On March 20, 2020, Governor Cuomo of the State of New York ordered all non-essential employees to stay home. As of this writing, similar orders have been implemented in 15 states.[11] Such executive orders cause major disruptions in the operations of non-essential businesses. It is very likely that a high percentage of them will not be able to re-open after the virus is contained. Mandatory closures and lack of revenue could cause borrowers to default on their equipment loans and lease payments.

As indicated above, the widespread reach of the COVID-19 pandemic has unfavorably impacted numerous industries and is expected to have a severe and long-lasting impact on receivable financings. In this scenario, most borrowers are expected to draw down on all or most of their available borrowing capacity under their existing credit facilities. Commonly, such financings incorporate the concepts of a borrowing base and a borrowing base deficiency, the occurrence of which not only precludes additional draws by the borrower, but if uncured (and many will be uncured) within what is typically a very short time period, will lead to an event of default. As COVID-19 continues to disrupt the markets, borrowers may be confronted with non-performance from contractual counterparties which will result in

[5] Full text available here.

[6] Full article "Careful or Careless? Perspectives on the CARES Act," *Brookings*, March 27, 2020, available here.

[7] Full article "What the Coronavirus Relief Bill Offers for Small Businesses," *CBS News*, March 25, 2020, available here.

[8] "From RMBS to SLABS: Is History Repeating Itself?," *The National Law Review*, April 3, 2019, available here.

[9] Full article "Education Dept. Will Stop Collections on Student Borrowers in Default," *NPR*, March 25, 2020, available here.

[10] Additional measures include: The Federal Reserve has implemented a number of measures to slow down the economic downfall. The Fed will provide liquidity to the primary dealers through a revived program called Primary Dealer Credit Facility. This will aid in keeping the credit markets functioning at a time of stress. The Fed also re-launched the crisis-era Money Market Mutual Fund Liquidity Facility ("MMLF"). Since the virus outbreak, investors have been withdrawing from money market funds and the MMLF should ensure the funds have enough liquidity to accommodate those requests. Additionally, the Fed lowered the rate that it charged banks for loans to 0.25% which is lower than the rate during the Great Recession. This should encourage banks to lend the money to consumers and accommodate withdrawal requests.

[11] Full list is available "State 'Shelter-in-Place' and 'Stay-at-Home' Orders," *FINRA*, March 27, 2020, here and "What is Shelter in Place and Which States Are on Lockdown Due to Coronavirus?," *Newsweek*, March 24, 2020, here.

borrowers' inability to meet their own obligations. Despite the actions taken by the U.S. Government, the markets are still facing the prospect of reduced liquidity. There is anxiety that lenders will refuse to fund draw requests due to concerns and unprecedented uncertainty surrounding the global pandemic. In the atmosphere of growing legislative sentiment for loan forbearance and payment freezes on consumer debt, any measures taken by lenders will need to be exercised with prudence to avoid potential liability.

Borrowers and lenders should review their loan documents carefully to determine the appropriate course of action at this time of uncertainty. Lenders may invoke the material adverse change ("MAC") clause in their credit agreements. Although rare, some definitions of an MAC may provide for carve outs of a certain systemic risk and allocate that risk to a lender or borrower. Most commonly, MAC is defined to cover a material adverse effect ("MAE") on a borrower's ability to perform its payment obligations under the credit documents or an MAE on a borrower's business, operations, financial conditions and assets. The occurrence of an MAC often constitutes an event of default ("EOD"). MAE definitions are heavily negotiated and differ greatly across agreements. The occurrence of an MAE is determined by either an objective test or in the lender's discretion. In most credit documents, the non-occurrence of an MAC or an EOD are conditions precedent for additional advances. Therefore, an MAC clause violation will allow lenders to decline the requests for additional funding. An MAC clause can be a powerful tool, but one that should be used with caution.

In most jurisdictions, the burden of proof that an MAC has occurred is on the lender. Courts offer no bright-line test to determine whether an MAC/MAE occurred. An MAC clause review is a highly fact-specific[12] and wording-specific inquiry. Both Delaware and New York have decided MAC cases mostly in the context of mergers and acquisitions, but still look to those cases as precedent for the MAC analysis in the financing realm. Both jurisdictions usually require a lender to prove that there has been an event or set of circumstances that has caused "persistent" and "continual" decline to a borrower's business.[13] For instance, rapid declines in a borrower's performance year to year (or, in limited cases, shorter terms) could be sufficient evidence that an MAE occurred.[14] As a rule of thumb, the greater the disruption, the stronger a lender's rationale will be. Additional evidence includes showing of the existence of a substantial threat to the overall earning potential of the business in a durationally significant manner.[15] The overall magnitude of harm to the market caused by COVID-19 remains unknown. This uncertainty may make it hard for lenders to prove that the operational health and financial soundness of a borrower will be affected for any significant period of time.

Since there is no consensus on the interpretation of MAC clauses, lenders contemplating invoking an MAC clause must possess a strong understanding of the facts used to support their decision. Other ways to avoid potential liability are to ensure that the response is proportional, commercially reasonable and in line with market practices. Finally, lenders should be mindful of reputational risks before making any material decisions. In addition to contractual obligations, lenders have a duty of good faith and fair dealing arising under the UCC, and, in certain jurisdictions, pursuant to common law.

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[12] IBP/Tyson Foods cases, *See* 789 A.2d 14 (Del. Ch. 2001).

[13] *See In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (2001).

[14] *See Pan Am Corp. v. Delta Air Lines, Inc.,* 175 B.R. 438 (S.D.N.Y. 1994)*; Katz v NVF Co.* 100 A.D. 2d 470 (N.Y. App. Div. 1984).

[15] *See Akorn v. Fresenius Kabi AG* C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018).

Lenders should also consider whether insurance may cover losses arising out of a party's inability to meet its obligations. Certain specialized insurance products, such as force majeure insurance, trade disruption insurance, political risk insurance or performance bonds may be utilized by lenders and borrowers to seek relief. In the wake of the SARS outbreak in 2002 – 2003, many insurance companies have since excluded viral or bacterial outbreaks from standard interruption policies.[16] Many commercial property insurance policies provide business interruption coverage. However, such policies often require direct physical loss to property of the insured, its customers or its suppliers.[17]

In the aftermath of COVID-19, courts and juries might be especially sympathetic to borrowers. Lenders will be judged in hindsight and there is potential for backlash, particularly because there is a strong regulatory push to allow borrowers to restructure and modify their loans. Since the inquiry into MAC/MAE clauses will be specific to their own facts and depend upon the exact definition of the MAC/MAE clauses, lenders should have a strong understanding of the facts and carefully evaluate their responses to potential credit risks. Lenders might consider evaluating other avenues, before exercising remedies under credit documents. There is a strong possibility lenders will face liability if their premature denial to provide additional funding or declaration of an event of default will cause the borrower to file for bankruptcy, become insolvent or simply go out of businesses. Lenders should consider communicating anticipated changes to borrowers based on the information provided by such borrowers and most recent financial data. In any event, all parties should undertake careful examinations of their loan documents with respect to notice requirements, potential impact on other agreements, insurance coverage and disclosure and clearly communicate their concerns to their counterparties.

Further, given the circumstances caused by the COVID-19 pandemic, lenders will need to carefully evaluate the impact of their exercise of remedies (including refusal to lend) on both their borrowers and their potential recoveries. Without any clear understanding of the magnitude of the problems facing borrowers (from a durational or financial perspective) or the ability of borrowers to recover from a protracted shutdown of the economy, bankruptcy courts will be ill-equipped to facilitate borrower restructurings, and the commencement of bankruptcy by a borrower may well lead to an immediate liquidation. Experience from the financial crisis in 2008 may not be a useful guidepost for lenders, borrowers or the courts as, in that instance the biggest problem was the absence of market liquidity — but at least the borrowers were still operational and functioning. That is not the case today, and the ability of borrowers to restart business and service debt (even if restructured) is not certain.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

To assist our clients in navigating the fallout from the current economic dislocation stemming from COVID-19, and in particular, the expected impact on financing transactions, Schulte Roth & Zabel has established the Economic Downturn Response Team. Click here for more information on the Team.

[16] Full article "Why Many Businesses Will Be on the Hook for Coronavirus Losses?," *The Wall Street Journal*, Feb. 21, 2020, available here, additional info "Policy Wording Critical as Businesses Assess Coronavirus Claims," *Insurance Business America*, Feb. 26, 2020, available here.

[17] Full article "Applying Commercial Property Insurance to COVID-19 Losses," *Law360*, March 12, 2020, available here.

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