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Coronavirus: What Lenders Should Do Now

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With cash flow, liquidity, and credit tightening drastically across industries, and in the face of historically low interest rates, lenders will face several new and unique challenges over the coming months as the full effects of the coronavirus pandemic are felt throughout the economy. Baker Donelson's Commercial Restructuring and Bankruptcy Group is monitoring and responding to the challenges of this changing environment for the benefit of our clients.

The scope of the pandemic's impact will be broad and deep. Experts are predicting significant negative impacts in the near and mid-term on capital markets and supply-chain networks, as well as the hospitality, transportation, and retail industries generally. Material declines in cashflow throughout the economy will make it difficult for borrowers to service debt, particularly for the many businesses that have increased their leverage during the economic expansion. Downstream vendors, manufacturers, and suppliers will be hit hard and likely forced to downsize aggressively. In the mid-term, commercial real estate will encounter difficulties refinancing the wave of maturities occurring over the next six to eighteen months.

As a result, we will see an increased need for restructuring across sectors, both inside and outside of formal bankruptcy proceedings. Energy, hospitality, transportation, manufacturing, and retail companies will need to restructure their financial obligations, raising a number of issues and action points for lenders.

Lenders should be on the lookout for the following issues:

- **Monetary Defaults** – With cash flow declining and credit restricting, many borrowers will outright default on their payment obligations. Lenders will have to analyze their options under their loan documents and practical considerations, given potentially limited access to courts, among other concerns, in determining the remedies that will be most effective in preserving and realizing value from their distressed assets.

- **Covenant Defaults** – Declining financial conditions will result in borrowers defaulting on an array of financial health covenants, including loan-to-value, debt service coverage, guarantor liquidity, and material adverse change provisions. In the mid-term, lenders can expect to see issues in borrower compliance with audit and going concern requirements as well. Lenders will need to decide whether and how to enforce remedies based on these defaults, including whether to discontinue advances under lines of credit, re-calibrate advance rates, and require borrowers to increase capital, pledge additional collateral, or provide other additional credit support, and to paydown existing obligations. The trend over the last few years of banks rescuing other banks from their troubled credits will doubtlessly be stifled.

- **Judicial Access** – Lenders, and all litigants, can expect more delays in court (whether federal district, bankruptcy, or state courts), as the number of cases creates backlogs and judges deal more leniently with debtors, at least initially. Obligors whose distress existed before and will be amplified by the pandemic will surely raise the pandemic as a defense to enforcement. Amid temporary closures and other restrictions on court access, and in-person proceedings in particular, courts are going to prioritize constitutional criminal proceedings and delay many aspects of normal civil proceedings, although many courts have made provision for continued civil access for emergency injunctive relief, including temporary restraining order (TRO) proceedings.

- **Foreclosure** – Whether secured creditors should commence (or proceed with) foreclosures will depend in part on the specific jurisdiction they are in and loan document provisions. In judicial foreclosure states, the judicial access issues noted above will impact foreclosures as proceedings slow across the board, making forbearance and modification options more attractive in appropriate circumstances. In non-judicial foreclosure states, lenders may fare better but should proceed cautiously. Many will recall that during the last financial crisis, a cottage industry of borrowers' counsel developed quickly with novel arguments to oppose foreclosure efforts; no doubt we will see similar strategies this time, such as the commercial reasonableness of holding a sale during the period of "social distancing."

- **Distressed Debt Market** – As in the last financial crisis, there will be investors looking to acquire distressed assets at bargain prices. However, many experts have noted that we are likely to see a significant lag time before these investors ramp up operations, as they deal with cash flow and liquidity issues themselves due to the unforeseen nature of the pandemic.

- **Practical Issues** – Social distancing and working remotely pose various logistical challenges despite the available technology. For example, obtaining signatures and notarizations can be more difficult outside of the office setting. At least some states are now permitting remote or virtual notarizations to address this issue. Lenders should not overlook these types of practical considerations in formulating their plans.

What Can Lenders Do Now?

To prepare and respond to the issues listed above, lenders should consider analyzing and stressing test portfolios in as much detail as possible by performing the following actions:

- Requesting and reviewing updated financial statements
- Reviewing assets for lien position, priority, and perfection issues
- Review covenants, grace periods, material adverse change, and force majeure clauses with an eye towards a framework for determining which assets are candidates for modification or forbearance vs. those requiring more aggressive positions
- Review level and scope of borrowers' business interruption insurance, upstream financial strength, and other potential sources to mitigate short-term financial hardship
- Review assets for intercreditor and cross-collateralization issues

As new legislation continues to be rolled out to combat the effects of the virus, lenders should monitor and be aware of the direct effects this legislation will have on them and their borrowers.

Baker Donelson is working hard to assist its clients during these uncertain times. Our team of professionals continues to monitor and advise on new issues as they develop. This Alert is a summary of what lenders should do; for specific guidance or more information please contact Matt Cahill or any member of Baker Donelson'sCorporate Restructuring and Bankruptcy Group. For additional information you can also visit the Coronavirus (COVID-19): What You Need to Know information page on our website.