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BANKING AND FINANCE

COVID-19: IMPACT ON FINANCING AND LIQUIDITY

The COVID-19 pandemic has already had a serious impact on existing contracts between suppliers and customers and between lenders and borrowers. The exact scale of the crisis is as yet unforeseeable and it is to be expected that its consequences will continue to be a central topic for a majority of market players well into the future. To counter the negative economic effects of the crisis, the German government is responding with a variety of support measures that are expected to have a significant importance on these contractual relationships and on the securing of liquidity by companies.

Financial covenants

A number of loan agreements provide for financial covenants which are tested at regular intervals (usually quarterly) on a rolling 12-month basis. A breach of these financial covenants constitutes an event of default, unless the company makes use of an equity cure (where such cure is available under the loan agreement). The decline in sales and profits due to the COVID-19 pandemic will have a long-term negative impact on companies' results. Where an event of default has already occurred or is likely to occur, this may also lead to undrawn loan commitments no longer being available and, especially in the case of revolving credit facilities, to the lenders denying a rollover of the current drawings. Especially where a loan is not rolled-over at the end of the interest period, but has to be repaid, this could lead to considerable liquidity problems.

Material adverse change

In addition to the German law statutory rules on termination of a loan in the event of a material adverse change, most credit agreements also contain their own provisions that very often deviate from the statutory model, some significantly. While some loan agreements stipulate that a material adverse change may not only be imminent, but must already have occurred, or that the material adverse change must affect the entire corporate group, others refer to future events or future business prospects and may, therefore, possibly lead to an event of default at a much earlier stage, which may not only entitle the lenders to accelerate the extended loans but may also cause a draw-stop or prevent an existing loan to be rolled over. Although some lenders may be reluctant to rely solely on the rather vague language of the MAC-clause in order to terminate a loan, it is possible that the COVID-19 pandemic may constitute an event which may cause lenders to make use of this provision. In light of this, borrowers should carefully review the relevant provisions of their existing financing agreements.

New loan agreements and loan commitments

Companies that have newly concluded credit agreements and that have not yet (fully) drawn down the commitments available thereunder should examine whether the current, possibly difficult environment still allows the commitments to be utilized. Certain types of financings, e.g. acquisition finance, include "certain funds" provisions. The terms of some of these financing agreements however, entitle the lender to refuse a disbursement of the loan in case of a material adverse change, e.g. at the level of the target company or in the market as a whole. The latter in particular could be critical in the current situation. The financing arrangements sometimes contain clauses that give the lenders the right to adjust the terms and conditions of the financing in the event of a change in certain circumstances (known as market flex clauses). Here, too, it is advisable to examine carefully the wording of the relevant documentation.

Securing existing liquidity

In a crisis like the present one, with all the uncertainty surrounding its length and impact, having sufficient liquidity is of utmost importance for companies. It may take some time before a decline in profits results in a breach of a financial covenant; however, a company may face a liquidity shortage even earlier. In this respect, it is far more important for companies to secure sufficient liquidity. Companies should ensure that existing credit commitments can be drawn and, in the case of revolving credit facilities, that outstanding loans can be rolled-over, if required. If there are doubts, then companies should consider securing their current liquidity and seeking a dialogue with their respective lenders.

German government's measures to assist business

The German government plans to provide not only for extensive rescue packages that include direct subsidies or the raising of emergency loans from the German state owned KfW (Kreditanstalt für Wiederaufbau), but also intends to adopt a number of other support measures for companies, including a temporary suspension of the obligation to file for insolvency and restrictions on termination rights for commercial leases.

1. Liquidity support

On 22 March 2020 the European Union approved two aid schemes planned by Germany to provide the following support:

- a loan programme covering up to 80 % of the risk for loans to large companies (and 90 % for loans to small and medium-sized companies), whereby the loans may have a term of five years and may be in an amount of up to EUR 1 billion, depending on the company's liquidity needs; and
- a loan programme in which KfW forms a consortium with private banks so as to be able to provide larger loans. Under this scheme, the risk covered by the state can be up to 80 % of a loan, but not more than 50 % of a company's total debt capital.

These measures will enable KfW to provide liquidity in the form of subsidised loans to companies affected by the outbreak of the COVID-19 pandemic. This will be done in close cooperation with the commercial banks.

For further information, please see our Client Update on state aid.

2. Restriction on termination of leases

The German government introduced a draft bill to mitigate the consequences of the COVID-19 pandemic (the Draft Bill) which provides that landlords may not terminate leases based on the late payment of the rent due in the period from 1 April 2020 to 30 June 2020, where failure to pay can be attributed to the effects of the COVID-19 pandemic. This rule not only applies to residential leases but also to commercial leases and may therefore help to temporarily mitigate the effects of liquidity shortages.

On the other hand, however, this restriction on termination could cause difficulties for companies that operate predominantly in the real estate industry.

3. Obligations to file for insolvency

The German government further intends to suspend the obligations around filing for insolvency for companies whose existence is at risk as a result of the COVID-19 pandemic. The requirements for banks that grant loans to such companies are also to be eased in order to reduce risks.

For further information, please see our Client Update on compliance and the coronavirus crisis.

German government's measures to assist consumers and micro-enterprises

On the other side, support measures for consumers and micro-enterprises are also envisaged, which in turn could have an impact on the liquidity of medium-sized and larger companies and may directly affect lenders.

1. Moratorium for essential long-term contracts

- As a further, very far-reaching measure, the Draft Bill provides for the introduction of a statutory right of consumers to refuse performance of long-term contracts if – as a result of circumstances attributable to the

- COVID-19 pandemic – performance would not be possible without jeopardising their reasonable livelihood or the reasonable livelihood of dependent relatives. This right to refuse performance applies in respect of all essential long-term contracts, being such which are necessary to ensure that the consumer's basic needs are met.

- Under the Draft Bill, a micro-enterprise has the right to refuse to perform its obligations until 30 June 2020 under a long-term contract concluded before 8 March 2020 if, as a result of circumstances attributable to the COVID-19 pandemic
  - it is unable to perform its obligations, or
  - it would not be able to perform its obligations without fundamentally jeopardising its business.

  The right of refusal exists in respect of all essential long-term contracts, i.e. those necessary to obtain services required for the reasonable continuation of the business.

- For both consumers and businesses, the right to refuse performance currently applies until 30 June 2020.

2. Loan agreements

- For consumer loan agreements concluded before 15 March 2020, the Draft Bill envisages a standstill by operation of law in regard of payments of interest and principal due between 1 April 2020 and 30 June 2020 for a period of three months from the due date if the consumer suffers a loss of income due to the exceptional circumstances caused by the spread of the COVID-19 pandemic, meaning that the consumer cannot reasonably be expected to make the payments due. Further, terminations by the lender due to a default or a material deterioration in the financial circumstances of the consumer, or of the value of collateral for the loan, are suspended during the standstill period. Lenders may not deviate from the above to the detriment of the consumer.
- This support measure also stipulates an obligation for the respective lenders and borrowers to enter into negotiations for contractual adjustments.
- At present, the Draft Bill only makes arrangements concerning loans to consumers. However, the government is going to be able to extend the protection afforded by this arrangement to include micro-enterprises. In addition, the government may also extend the arrangements to include payments of interest and principal that fall due in the period up to 30 September 2020.
- It would be worth considering extending these arrangements to larger companies that may also be affected by the crisis. An extension of this kind would be a further form of much-needed support to secure the liquidity of such companies.

For further information, please see our [Client Update on contract law].

Conclusion

Companies could quickly suffer liquidity shortages as a result of the current COVID-19 crisis. The government's support measures for consumers and tenants may also have a direct impact on liquidity. Therefore, companies should review the restrictions in their financing agreements in terms of access to liquidity and events of default and, swiftly enter into negotiations with their financing partners, if required.

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