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DEBT FINANCING ARRANGEMENTS AND COVID-19'S IMPACT THEREON

Introduction:

As we continue to witness the impact of the COVID-19 outbreak on Indian as well as international trade and commerce, particularly in light of the uncertainty surrounding the ability of businesses to a) raise fresh debt in the wake of cautious institutional lending sentiment; and b) service existing debt obligations due to temporary suspension of business, we ask three important questions:

1. *How does the COVID-19 outbreak impact the borrower's ongoing debt financing arrangements?;*

2. *How should a borrower deal with their lenders during a period of tight credit or uncertain economic times?*

3. *What mitigation measures have been introduced by the Reserve Bank of India (RBI) in order to alleviate the stress in the financial sector and mitigate the burden on debt-servicing caused due to disruptions on account of COVID-19 Pandemic?*

How does COVID-19 impact the ongoing debt financing arrangements of businesses?

Force Majeure:

Conventional facility agreements (such as those based on Asia Pacific Loan Market Association (APLMA) documents), are designed to ensure that borrowers have little room to argue that difficulties caused by scenarios akin to the COVID 19 outbreak, releases them from their repayment obligations. Unlike ordinary commercial contracts, facility agreements generally do not include a 'force majeure' clause and placing reliance on the common law doctrine of 'frustration' is also unlikely to serve as a mitigation measure as the ongoing pandemic does not make the payment of money strictly impossible and it certainly does not change the 'sub-stratum' or the fundamental underlying premise of the contract. Accordingly then, borrowers will be required to carefully review their financial documents in order to fully consider the possible ramifications of the COVID-19 pandemic.

Material Adverse Effect:

Conventional facility agreements do however include material adverse effect (MAE) provisions which are specifically represented in repeating representations and warranties clauses and often even constitute an event of default (EOD). Depending on the borrower's negotiating power, MAE clauses may either be broadly defined to include scenarios impacting the borrower's ability to perform 'any' of its obligations under the finance documents; or maybe narrow in their outlook, being triggered only where a particular business or operation is effected or where the entire borrower group is impacted. While MAE provisions are common they are heavily negotiated between the borrower and the lender and hence would need to be considered on a case by case basis. Therefore

the triggering of an MAE clause is ultimately a question of contractual interpretation, unless of course the facility agreement explicitly gives one party the specific right to call for and determine the occurrence of an MAE event.

In our experience, it is uncommon for lenders to use MAE as a ground for defaulting a facility, as was the case during the global financial crises in 2008.

Temporary Halting of Business Operations

Suspension or cessation of all or a material part of a borrower's business is often included as an EOD under conventional facility agreements. While it is unlikely that lenders will presently call for a cessation of business EOD during a government mandated 'Lockdown', such EOD clauses do not usually have a specific carve out to exclude temporary business closure ordered under law through emergency executive action. The right to call for such an EOD therefore technically remains with the lender and like the MAE, this clause will be subject to contractual interpretation (depending heavily on the borrower's relationship with the lender) as to what constitutes a 'material' part of the business and for how long would an interruption of this nature constitute a 'cessation' of the business.

Financial Covenants

Conventional facility agreements also require borrowers to adhere to certain prescribed financial ratios (such as debt to income ratios, interest coverage ratios, etc.) The temporary cessation of business operations of a borrower may negatively impact their ability to maintain such ratios and therefore depending on each borrower's financial capability, they would need to immediately alter their short term business strategies (such as delaying substantial asset acquisitions, reducing their overhead costs outlay, refinancing/renegotiating other short term debt obligations, delaying payment of dividends, etc.) in order to ensure that their financial covenants are not breached.

Cross Defaults and Material Contracts

Most financing arrangements particularly within the segment of project/infrastructure finance require the borrower to ensure that they are not in default under any other material commercial contracts (for example supply contracts and construction agreements). Therefore, the failure to meet one's payment obligations towards its supplies and/or business partners under other commercial arrangements can trigger an EOD under the concerned financing arrangement for cross default. While some cross default provisions provide for a numerical threshold value for when a cross default EOD is triggered, borrowers must undertake a review of such provisions in order to prioritise payment obligations.

How should a borrower deal with their lenders during a period of tight credit or uncertain economic times?

In the present environment of financial uncertainty borrowers should pay special attention to monitoring and complying with their facility agreements while maintaining constant communication with their lenders in order to maintain a successful working relationship with them.

During these times, institutional lenders may themselves be facing a liquidity crunch and may look to recover their capital in various ways. Such lenders may seek to assign the facility extended to a borrower (which may or may not require the borrowers consent depending on the facility agreement and consent having been already built into it). In such a scenario, the borrower may

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nevertheless be aware of who the assignee is and must make an informed decision whether to grant consent (if such right is available to the borrower). If the borrower has no consent right over the assignment, and the person to whom the loan is being assigned to has goals which are incompatible with that of the borrower such as in the case of a 'vulture fund' or a distressed debt lender, it may look to foreclose the loan by employing capital from alternative financing sources.

Borrowers must try to ensure compliance with the terms of their facility agreements and avoid asking for major amendments and waivers, as having to do so may provide an opportunity for lenders to change the terms of the facility agreement, tightening covenants, increasing pricing, require enhanced security package and/or adding further clauses favourable to the lender, in exchange for such temporary relaxations and waivers. In order to ensure such compliance, borrowers must ensure that its key employees (heads of departments for operations, finance, and legal) understand the terms of the facility agreement and have set up procedures to maintain its compliance including by educating staff members that any transaction that the borrower contemplates may trigger a covenant breach; and by maintaining a compliance calendar of payment dates and delivery dates for periodic reporting requirements and other borrower actions required under such facility agreements. Borrowers should also ramp up monitoring of financial covenant calculations and of situations that may trigger mandatory prepayment and event of default provisions of the facility agreement.

Borrowers should also ideally avoid informing lenders of any adverse impact on their business at the very last moment and should preferably provide lenders enough time to help them find a mutually beneficial solution to the borrower's predicament rather than force a knee-jerk decision.

Given the current circumstances, the borrower may also consult with lenders regarding refinancing options and whether an amendment to the existing facility agreement in order to extend the maturity date or reduce interest rates would be possible.

Finally, if an upcoming default is inevitable under a particular financing arrangement, depending on the specifics of the situation a number of options may be available:

- Seeking a temporary waiver, suspension or amendment from the lenders regarding the anticipated or actual breach;
- Requesting an extension of the maturity dates or instalment repayment dates and/or a general payment deferral (for example, capitalising upcoming interest obligations);
- Boosting liquidity by raising new debt/working capital and/or equity capital;
- Sale of assets (including sale and leaseback arrangements) to generate additional capital;
- Where a default waiver is not available, then seeking an enforcement standstill arrangement from the lenders in order to garner sufficient time to devise and execute a suitable turnaround plan.

The fundamental objective is to promptly initiate discussion with lenders in order to formulate some form of short term relief which may then be translated into longer term restructuring solutions.

What mitigation measures have been introduced by the Reserve Bank of India in order to alleviate the stress in the

financial sector and mitigate the burden on debt financing arrangements caused due to disruptions on account of COVID-19 Pandemic?

Realising the possibility of a significant increase in debt repayment defaults in absence of government mandated guidance to banks and financial institutions and heeding to calls from the industry requiring it to spearhead a co-ordinated approach from the regulator, the Reserve Bank of India (RBI) has been relatively quick to take remedial actions in order to relieve the stress faced by the financial sector due to the COVID-19 outbreak. In addition to taking several measures as a part of its Seventh Bi-Monthly Policy[1], the RBI has notified a special 'COVID-19 Package'[2] with the specific aim of mitigating the burden of servicing debt caused due to the COVID-19 outbreak. These measures *inter alia* include a moratorium on term loans, deferring interest payments on working capital and easing of working capital financing. While the implementation of these measures is raising new queries each day, we have attempted to analyse some of the key measures announced by RBI in greater detail below.

3 Months Moratorium:

RBI has 'permitted' lending institutions i.e. all commercial banks (including regional rural banks, small finance banks and local area banks), co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies) to 'allow for' a moratorium of three months for payment of all instalments falling due between March 1, 2020, and May 31, 2020 'for all term loans including agricultural term loans, retail and crop loans'. RBI has also explicitly clarified that: a) the repayment schedule for such loans as also the residual tenor, will be shifted across the board by three months after the moratorium period; and b) Interest shall continue to accrue on the outstanding portion of the term loans during the moratorium period.

In respect of working capital facilities sanctioned in the form of cash credit/overdraft, lending institutions have been permitted by RBI to defer the recovery of interest applied in respect of all such facilities during the period from March 1, 2020 upto May 31, 2020. However, RBI has explicitly stated that the accumulated accrued interest shall be recovered immediately after the completion of this period.

Firstly, it may be noted that such moratorium is not granted automatically and has been left to the discretion of the lending institutions that have merely been permitted by RBI to grant such a moratorium for three months. This moratorium in effect acts as a restructuring of the terms of the loan with the mutual consent of the lender and the borrower. The consent of the lender may be in the form of the lender's circular or notice and the consent of the borrower may be obtained under a "deemed consent unless declined" option.

Nevertheless, Appellate Courts in India have relied upon the RBI's COVID-19 package notification to order banks to the maintain status quo on existing loans and have prevented them from downgrading existing facilities during the moratorium period. There has been a ruling of the Delhi High court in ***Anantraj Limited vs Yes Bank*** *vide* an order dated April 6, 2020 in response to a writ petition, where the court has stated that

[1]https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR21302E204AFFBB614305B56DD6B843A520DB.PDF

[2]https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11835&Mode=0

there will be no transformation of a standard account into an NPA, since before an account becomes an NPA, it has to pass through SMA 1 and SMA 2, and as per RBI's own admission, there will be no downgradation of the status due to the moratorium.

Secondly, it is the discretion of the lending institution whether to allow a moratorium of upto three months or not. It is not compulsory to provide for a moratorium for the entire three months and lending institutions may allow for a shorter moratorium period as well.

Thirdly, though the moratorium is a payment holiday, interest on the outstanding principal amount will continue to accrue during this time period. For working capital facilities, the accumulated interest for the period will be paid after the expiry of the deferment period.

Fourthly, we understand that financial leases are akin to loan transactions and have rental payouts similar to EMIs in case of a term loan. Hence, lessors under a financial lease may confer the benefit of the moratorium under the RBI circular as well. However, operating leases are not considered as financial transactions and hence, they shall not be covered under the RBI circular for granting moratorium.

Lastly, it may be noted that in the recent past several businesses have moved away from traditional financing arrangements through banks and have instead sought structured debt financing from NBFCs and other private lenders through the private placement of debt instruments such as debentures and bonds. Unfortunately, RBI's COVID-19 package does not extend to financing raised through such debt instruments, the terms of which are often quite onerous for the borrower.

Ease of Obtaining Working Capital Financing:

In respect of working capital facilities sanctioned in the form of CC/OD to borrowers facing stress on account of the economic fallout of the pandemic, RBI has permitted lending institutions to recalculate the 'drawing power' of such borrowers by reducing the margins and/or by reassessing the working capital cycle. The provision of such relief has been left to the discretion of the lending institutions and has been made contingent on the lending institutions satisfying themselves that the same is necessitated on account of the economic fallout from COVID-19. RBI has even placed a check on discretionary/ unbridled lending during this period by expressly clarifying that accounts provided relief under these instructions shall be subject to subsequent supervisory review with regard to their justifiability on account of the economic fallout from COVID-19.

While the RBI has permitted lending institutions to be relatively more free with respect to the provisions of working capital to businesses during this period economic uncertainty, it has left a lot of discretion with such lending institutions to judge the actual financing need of such businesses which, as per the RBI, can only be specifically bought about only on account of the "economic fallout from COVID-19". In the absence of any specific lending targets and with the threat of 'supervisory review' requiring justifiability of such lending, it remains to be seen whether lending institutions actually provide such working capital support to the business in a robust manner, or this alleviation measure from the RBI remains a mere lip service.

Conclusion:

There is significant uncertainty still surrounding the extent to which COVID-19 mitigation measures such as the lockdown, travel bans, factory shutdown etc. shall continue and till when. Given these scenarios, decision making for both borrowers as well as lenders has become challenging. While lenders are wary about hastily calling defaults at this point in time, if the mitigation measures such as the lockdown were to continue for a period longer than anticipated, they too will have to consider ways to recover their capital. Borrowers need to be in constant communication with their lenders in order to demonstrate the financial viability of their business during these times and how they are containing or otherwise managing the effects of the COVID-19 outbreak on their businesses. Borrowers may also wish to consider alternative means of financing and credit through issuance of corporate debt instruments to institutional investors, private equity, promoter equity infusion, etc. to tide over any temporary liquidity pinch they may be facing in servicing their existing financing arrangements, even though the cost of such financing may be significantly higher under the prevailing circumstances.

While RBI's COVID-19 package is helpful for borrowers facing a temporary liquidity crunch, it does little to alleviate the ongoing economic stress faced by businesses due to shutting down of business during the lockdown while still being mandated to cover overhead costs such as salaries, rentals etc. A more robust stimulus package with a greater easing of regulatory restrictions in order to boost business is the need of the hour and is expected by the industry.

In short, rather than relying on regulatory crises alleviation measures such as RBI's COVID-19 package, it is recommended that businesses should be proactive in order to ensure that the existing financing arrangements are not jeopardised in the wake of the COVID-19 outbreak and measures described above are immediately undertaken in relation to one's financing arrangements.

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