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How PPP Loans May Impact a Borrower's Primary Loan Facility

The COVID-19 pandemic potentially impacts a number of loan document provisions. We covered "Material Adverse Effect" already. Here are five more possible issues for borrowers and lenders to navigate together:

1. Stimulus Loans

Many companies are applying for Paycheck Protection Program (PPP) loans under the CARES Act or SBA Economic Injury Disaster Loans. Additional stimulus programs are in the works, too.

Before taking advantage of any of these stimulus programs, a borrower should consider the ramifications doing so would have on its current credit facility.

First, the borrower must ensure that the stimulus loan is permitted under its existing loan documents. Most loan agreements generally prohibit the borrower from incurring additional debt – especially debt owed to another lender. But even where the stimulus loan is extended by an existing lender, it might still be prohibited. A borrower should carefully check the kinds of debt permitted and work with its lender to obtain any needed amendments or consents.

Second, all PPP loans are required by the program to be unsecured. Security documents often include a dragnet clause whereby all debt – not just the debt under the existing credit facility – from the secured lender to the borrower is secured by the collateral. If the PPP loan is being made by an existing secured lender, and the security documents have such a dragnet clause, then the PPP will inadvertently be secured. In such a situation, the PPP loan will need to be carved out from the obligations that are secured by the collateral.

Third, the borrower should examine how the stimulus loan will affect the financial covenant calculations under the existing loan documents. For example, in a leverage ratio (debt to EBITDA), the numerator (debt) may need to exclude the amount of the stimulus loan or else the calculation would be inflated. In a fixed charge coverage ratio (EBITDA to fixed charges), the denominator (fixed charges) might be increased due to the interest payments on the stimulus loan. The borrower and the lender should discuss these effects and potentially amend the financial covenants to remove any undesired impact of the stimulus loan.

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Finally, a credit agreement for a highly leveraged borrower might require that the net cash proceeds of any debt incurrences (outside of the existing facility) – such as a stimulus loan – be used to pay down the outstanding loans.

A lender will want to understand what stimulus programs its borrowers are intending to use, and what strings are attached to any stimulus loans. Further, a stimulus loan application might reveal information about a borrower that a lender otherwise did not have. A lender might therefore consider mandating that a borrower:

- Notify the lender of its loan application (together with copies of the application materials) under any stimulus program and receipt of any stimulus loan proceeds; and
- Comply with the applicable stimulus loan program criteria so that the borrower maintains eligibility for any potential loan forgiveness under the program.

2. Borrowing Base Availability

In an asset-based loan (ABL) facility, a company's borrowing base is limited to a certain percentage of the borrower's eligible inventory and eligible accounts. When those inputs decrease, so does borrowing availability.

A borrower might want to request a relaxation (even if only temporary) of the eligibility criteria. The pandemic is causing supply chain disruptions, which could ultimately reduce a company's inventory levels. In addition, if account debtors fail to make payments, accounts could become delinquent or defaulted – and hence ineligible under the borrowing base. Moreover, many ABL facilities give the lender discretion, in good faith, to impose additional reserves against the borrowing base.

A reduced borrowing base can also trigger a mandatory prepayment obligation. If the borrowing base shrinks below the amount currently outstanding under the line of credit, the borrower is obligated to pay back the excess.

3. Business Interruption Insurance

Many companies are making claims under their business interruption insurance, hoping that pandemic-related losses are covered. Whether such losses will be covered is an open question. Borrowers should check the definition of EBITDA in their loan documents to see whether any proceeds of business interruption insurance claims can be added back to EBITDA (to the extent not already included

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in net income). Borrowers should further note that some credit agreements require a borrower to prepay the outstanding loan to the extent the borrower receives any casualty proceeds.

4. Defensive Draws (Preemptive Draws)

In light of historically low interest rates, market uncertainty and concerns about liquidity, many borrowers have drawn down a significant portion of their lines of credit. A borrower should beware that – even though it might then have the cash on hand – if the cash is parked in an account with a secured lender, the lender can take control over the account after a default. In addition, a large defensive draw might trip up a “minimum availability” requirement. Finally, a borrower should consider whether a large defensive draw will spook a lender into scrutinizing the borrower and its situation more closely.

5. Cessation of Operations

Some loan documents contain a covenant or event of default requiring the borrower to at all times continue conducting its business. This kind of provision does not ordinarily make a distinction for the cause of the closure – whether it be (i) market or business forces; (ii) a voluntary decision in order to keep employees safe; or (iii) a government “shelter in place” order. If, in connection with the pandemic, a company ceases to conduct all or a significant portion of its operations, then there might be a default.

If you have any questions about the impact of the COVID-19 pandemic or PPP loans on your existing loan documents, please contact your Reinhart attorney.

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