Business Loan Covenants and the Pandemic – What to Do to Avoid Default

A Back to Business Article

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Large and small businesses are dealing with the fall-out from COVID-19. At Shields Legal Group, we want to give practical, actionable steps for you to take inside your business during the COVID-19 pandemic. That's why we created Back to Business, a place where you can go to learn more about navigating these uncertain times.

Today's focus concerns business loans and how to avoid default. The key is to comply with the notice provisions in your loan documents and communicate with your lender.

Paradise Events and Their Line of Credit

Brad Johnson owns and manages his company, names "Paradise Events." Ten people work for the company, booking venues and supplying tables and chairs for significant events. In January of 2020, Paradise Events opened a line of credit to purchase more equipment and open a new location.

In March, the Dallas County order to shelter-in-place took effect. Since Paradise Events was deemed "non-essential," the entire operation shut down. At first, Johnson panicked, because he knew that the line of credit payment was due in one week. Then he remembered what his lawyer always said, "When things change drastically in your company, be sure to let your banker know."

Johnson pulled out the line of credit loan documents and tagged the provisions that seemed to be triggered by the government's order. There were several provisions, including financial covenants, a notice of force majeure events, and a notice of a material adverse change in financial condition.

Loan Covenants to Identify

The following covenants were flagged:

1. Financial Covenants:
Paradise Events was no longer in operation because of the governmental order. Johnson knew that he did not have the resources to meet the financial covenants and payment obligations required by the line of credit.
He reached out to his banker and scheduled a call to discuss how to proceed. He proposed a mitigation plan and a loan modification schedule that would benefit the bank and Paradise Events. The current situation was not the first time that Johnson had to work with his bank during difficult financial times. The coronavirus was no different than other difficult times in the past.

2. Information Covenants:
After reading the loan documents, Johnson realized that his loan required him to provide certain information to his lender. One of the main requirements was to notify the bank of a force majeure event that could reasonably be expected to have a material adverse effect on Paradise Event's business. Johnson met the notice requirement of 14 days when he immediately sent the written notice to his banker and called them to discuss the situation.

3. Events of Default:
Digging into the loan documents, Johnson also read that a suspension or an abandonment of a project could constitute an event of default under the loan documents. Johnson heaved a sigh of relief when he realized that his attorney had wisely negotiated a carve-out clause. The clause in the loan documents stated that a force majeure event would not constitute an event of default.

4. Material Adverse Change:
Under the representations and warranties section of the line of credit documents, Paradise Events represented and warranted that the borrower's financial and business condition is in good standing and able to satisfy all of its contractual obligations. In his written notice to the bank, Johnson also described the material and adverse change in the company's financial and business condition because of the government order. He made sure to comply with the notice provisions required to notify the bank of any material adverse change in Paradise Event's financial and business condition.

Although it took several calls, Johnson was able to negotiate with his bank. Bob Smith, the banking relationship manager, remarked that Paradise Events has been a trusted partner with the bank for twenty years and continues to be an important client. By being communicative and responsive, the bank agreed to a loan modification schedule that worked out for everyone.

The pandemic has created disruption and havoc for small businesses. Individuals and company borrowers should be organized and attentive to loan covenants that are triggered by government shut-down orders. Review the relevant loan documents and take proactive steps to communicate with the lender timely is critical.