Navigating credit distress in difficult times

The COVID-19 pandemic has caused an enormous amount of disruption. Social distancing has entered the popular lexicon and what were formerly routine acts such as flying or taking public transit, going out for dinner and a show, shopping at the mall or working out at the gym have become less and less possible as infection rates have increased.

The first impacted countries have demonstrated that ordinary life eventually returns and hopefully valuable lessons will be learned on mitigating the impact of pandemics. But the Canadian economy is being acutely affected by the viral outbreak and businesses are experiencing significant revenue declines while still having to pay their bills.

Many companies have strong balance sheets or access to capital, insurance or government funds that will enable them to survive and even emerge stronger than in the pre-pandemic period. But others are facing challenging situations. Policy makers are encouraging banks to keep lending in order to pump liquidity into the economy. They will likely comply but also try to avoid lending money to failing enterprises. Watch lists will grow and account and relationship managers and special loans personnel will be actively managing distressed accounts.

What should you do? Are there recommended courses of action? Below are five key considerations examined from the borrower’s and bank’s perspective for navigating credit distress in these difficult times.

1. Understand your loan terms

Many borrowers and even lenders often do not fully grasp their contractual rights and obligations. Credit under committed facilities generally must be advanced if the borrower can satisfy the conditions. Where circumstances may change in the future, a borrower may wish to preemptively draw down the facility to avoid a situation where the funds are unavailable when actually needed.

At the same time, a concerned lender may wish to carefully consider whether it has any reasonable grounds to reject a drawdown request even if the borrower is technically compliant where there is a likelihood that the borrower’s circumstances will change in the near future. Material adverse change clauses, updated valuations and financial covenant calculations and other measures may be used to at least buy time. While any delay may introduce litigation and reputational risk (especially where the delay negatively impacts the borrower’s business), in certain limited cases this may be preferable to advancing funds with little chance of repayment.

Uncommitted facilities only require a lender to act reasonably and in good faith when considering a drawdown request with no attendant obligation to advance funds. Lenders are advised to document their loan deliberations in the event litigation ensues in order to demonstrate to a court that they fulfilled their duties. Borrower’s facing potential distress may wish to draw down these facilities as soon as possible even if it means absorbing extra interest costs.

Any aggressive action should be balanced with concerns over how it will impact the relationship between the banker and customer. Relationship considerations are discussed below.

2. Review your credit support: security and guarantees

Credit support such as security and guarantees are often provided to lenders to support a borrower’s loan obligations and increase the size and availability of credit lines. Credit support is intended to provide a lender with additional comfort that it will be repaid and recourse to assets and other obligor(s) if it is not.
Now is a good time for lenders to undertake reviews in order to update their credit coverage analyses and identify and fix any gaps or mistakes in the documentation which might impact a recovery action. For distressed accounts (current or expected), it may be prudent to engage a lawyer to review the documentation in order to obtain professional advice on the overall package including its scope, validity, enforceability, perfection and any potential priority issues. A lawyer can also advise on relevant provincial and federal laws which may affect a lender’s rights and recommend solutions before matters become critical.

For borrowers, having unencumbered assets may allow for obtaining continued or additional credit from an existing or alternative lender. Personal guarantees may be a complicating factor should the underlying business be teetering on the brink as it introduces a risk of personal liability. A lawyer can advise on various strategies in each of these instances.

3. Have open and frank discussions with your bank / customer

Building trust through voluntary and forthright communication can go a long way towards successfully navigating difficult situations. Banks prefer to keep good customers and they do not like surprises so if a customer is being honest and forthright, they are more likely to try to work with them through difficult situations.

At the same time, being in regular communication with a relationship or account manager may help to avoid issues and keep them on side. Where current arrangements become untenable, a friendly banker may be more likely to recommend to his or her credit risk group a workable amendment or forbearance arrangement.

Of course, communication must be balanced with prior dealings and if there is a general lack of trust between parties, a more aggressive approach may be necessary.

4. Consider amending loan terms or entering into a forbearance agreement

These are related but different concepts and usually only become relevant in situations requiring more serious action. Straight loan amendments may occur at any time and do not require defaults or the prospect of a default. Forbearance agreements are entered into when there has been or is about to be a default or other breach.

Both cases result in amendments to the loan terms. For forbearance agreements, the lender will also waive the default or breach in exchange for consideration – which may include such things as an increase in the loan interest rate, a modified repayment schedule, additional fees and more credit support.

Lenders may benefit by working with its customer to avoid an unfixable default. The lender gets to retain the customer while being compensated and/or obtaining increased protection in the event of a future default. They may also be able to implement an orderly customer exit. The borrower gets to keep its banking relationship (at least temporarily) which may be crucial in surviving serious financial distress.

5. As a last resort: is bankruptcy or a court-supervised restructuring appropriate?

When all else fails, bankruptcy or a formal restructuring proceeding (such as a BIA proposal or CCAA restructuring) may be appropriate. A business may not be salvageable in which case, it may be best for all parties for its unpledged assets and estate to be administered by a licensed bankruptcy trustee. Businesses needing the time and structure provided by the insolvency statutes to compromise debts, recapitalize and reorganize may wish to take advantage of the proposal provisions of the Bankruptcy and Insolvency Act or, for larger enterprises, the restructuring provisions of the Companies’ Creditors Arrangement Act.

Navigating the current climate is challenging. For businesses trying to maintain liquidity and banks managing distressed accounts, there are several steps and considerations which should be followed to mitigate the risk of negative outcomes. For additional information or to speak with a lawyer experienced in these areas, please contact us.

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