HERBERT SMITH FREEHILLS

COVID-19: PRESSURE POINTS: MANAGING LIQUIDITY (UK / EMEA)

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Legal Briefings

The COVID-19 global pandemic is above all else a humanitarian crisis. In response to the rapid spread of the disease, governments around the world are taking unprecedented measures to protect the health of their citizens. As both economic production and consumption contract rapidly, individuals and business alike are facing cash flow difficulties. We consider below the options open to companies focused on managing liquidity.

SUMMARY

The consequences of the pandemic and the associated public health measures may pose significant threats to the supply and demand sides of many businesses. Effects include reductions in capacity and output, supply chain failures, drop-offs in demand, and deferrals and defaults affecting payments. In turn, these effects are putting cash flows under pressure, meaning that companies are having to consider the options available to them to improve liquidity. These options include:

- **Cutting costs** – The most immediate action a company can take in a sharp downturn is to reduce its costs. Certain expenses may shrink naturally but other expenditure should be scrutinised carefully. Directors should take particular care when considering and paying distributions. Opportunities to conserve cash may be found in both fixed and variable costs. Where cost reductions involve shuttering businesses or headcount reductions, the wider implications should be carefully considered.
- **Government assistance** – National governments continue to introduce packages

designed to offer varying forms and degrees of relief from the financial and economic effects of the pandemic. Schemes include direct lending, guarantees of bank borrowings, relief from taxation, the underwriting of payroll costs and changes to insolvency frameworks. Businesses should determine eligibility for available reliefs and take care to comply with applicable rules.

- **Debt finance** – Companies will wish to identify any "headroom" remaining under existing facilities and any "drawstops" that may affect their rights to draw down funds. Covenants may need to be reset and other terms adjusted in order to avoid formal defaults. Where additional borrowing is in contemplation, new equity may first need to be injected.

- **Capital calls** – Businesses with strong fundamentals or which are of national importance may be able to repair balance sheets either by calling for new capital from investors or seeking a bailout from government. However, market volatility (affecting pricing), financial viability requirements and process timeframes may limit volumes in the near term. State aid rules will apply to Government bailouts.

- **Insurance** – An insurance policy which responds to disruptions caused by the COVID-19 outbreak is an asset for the companies insured. Relevant policies should be thoroughly reviewed for potential claims and requisite notifications. It is critically important to follow precisely any prescribed claims procedures.

- **Asset disposals** – Companies may wish to consider asset carve outs and strategic disposals as a means of realising capital. The effects of market dynamics and execution risks should be taken into account before pursuing a disposal. Particular complexities may affect price discovery, acquisition financing, certainty of funding, and the practicalities of due diligence. Political intervention is also likely in the case of strategically significant or politically-sensitive assets.

We explore each of these means of managing liquidity in greater detail below and suggest steps that companies should consider in the short term and in the months ahead. We would expect various combinations of these options to be adopted by companies facing a cash crunch. In every instance, directors must take particular care to discharge their legal duties to the company and its shareholders and creditors.

CUTTING COSTS

The most immediate action a business can take is to reduce its costs and expenditure.

- **Discretionary spending** – Companies should review all discretionary spending and cut it out where possible. Some costs, such as travel and hospitality, will reduce by virtue of the restrictions put in place by governments around the world but companies should

review all expenditure to identify where cost savings can be achieved both in the short term, while work patterns are disrupted, and looking ahead as normality resumes.

- **Dividends** – All companies should consider whether it is appropriate to proceed with any proposed dividend payments, even if they have sufficient distributable profits. Where a dividend has already been announced or proposed, it may be possible to withdraw it, for example by not putting forward, or withdrawing, any resolution required to approve the dividend. We have already seen a number of companies pause or cancel their upcoming dividends.

- **Employees** – For many companies, a significant overhead is likely to be its employees. Many employees may be at home, either because of government advice to stay at home wherever possible or because they are ill or need to self-isolate. In some instances, employees will be able to continue to work from home. For employees who cannot work from home or where governments have ordered the temporary closure of workplaces, a company should investigate what government assistance with employee costs is available, such as the UK job retention or "furlough" scheme. In some cases, employers may need to consider negotiating reduced hours and/or pay, or ultimately reducing headcount, but should take into account the potential for industrial relations issues and adverse publicity when deciding what approach to take.

- **Premises** – Another significant overhead for a company may be the rent it pays for its business premises. A company should identify whether there is any governmental package for rent relief. In the UK, there is no program for government relief for rent at the moment but a landlord's entitlement to repossess business (and residential) property is currently suspended. However, this does not stop a landlord from enforcing in other ways, such as making a claim for the debt or drawing down on a rent deposit, or instigating insolvency processes such as serving a statutory demand. Companies facing difficulties should contact landlords as early as possible to discuss possible options. Landlords do not have to accommodate tenant proposals. However, it appears that some have agreed to rent deferrals when approached. Business interruption insurance policies should also be checked for possible cover.

Immediate steps
Audit discretionary spending
Review and consider pausing any upcoming dividend payments
Explore government packages for support with employees and rental costs

Looking further ahead

Assess overheads and identify where cuts are achievable without impacting the business

Maintain revenue collection

Understand your cash flow forecast

GOVERNMENT SUPPORT PACKAGES

Governments around the world are putting in place a wide range of measures to try and alleviate the financial and economic impact of COVID-19. These include:

- providing financing directly to companies;
- underwriting debts payable to lenders;
- underwriting payroll costs;
- deferring tax payments;
- introducing a moratorium for companies to give them space from creditors while they seek a rescue or restructure; and
- relaxing legal requirements imposed on directors of companies facing insolvency.

In each case, there may be eligibility criteria to determine who can take advantage of the various support packages. It will be important for each company to assess what support is available to it and what protection it affords.

Two examples of support packages in the UK are:

- **Covid Corporate Financing Facility (CCFF)** – The CCFF is a fund operated by the Bank of England (BoE) to provide funding to businesses by purchasing debt instruments (commercial paper) of up to one-year maturity from issuers who “make a material contribution to economic activity in the UK”. The aim of the CCFF is to assist corporates during a time when they are likely to experience severe disruption to cashflows. The CCFF will only be available to corporates who meet certain ratings and other criteria. It is intended to operate for 12 months and the BoE will provide 6 months' notice of withdrawal. The BoE has said that the following issuers will usually be eligible: (a) UK companies, including those with foreign incorporated parents, with a genuine business in the UK; (b) companies with significant employment in the UK; and (c) companies headquartered in the UK. The following issuers will also be considered: (a) companies generating significant revenues in the UK; (b) companies serving a large number of customers in the UK; and (c) companies with a number of operating sites in the UK. Companies who do not currently issue commercial paper but who are capable of doing so

will be able to access the CCFF (provided they meet the eligibility criteria); they will need to set up a commercial paper programme, which can be done relatively quickly.

- **Covid Business Interruption Loan Scheme** – The Government will provide support for small and medium sized enterprises (SMEs) through this new temporary scheme. SMEs with a turnover of less than £45 million per year which are UK-based in their business activity will be able to access the scheme via their usual lender (or another accredited lender). It will operate by providing lenders with a guarantee of 80% of each loan to an SME. The government will not charge businesses or banks for this guarantee. The scheme will support loans of up to £5 million in value and will cover the first 12 months of interest payments and lender-levied fees.

Companies will have to be cognisant of the EU rules on State aid if they are looking to take government support (and these rules still apply in the UK during the transitional period following the UK's exit from the EU). Whilst the European Commission has introduced significant relaxation of State aid restrictions in light of the current climate, companies should be aware that they may be forced to pay back non-compliant State aid, increased with interest.

Immediate steps
Assess government funding options and check if the company meets the criteria
If necessary, set up a programme to enable issuance of commercial paper

DEBT FINANCE

The ability to access existing, restructured or new debt financing will depend on a number of factors such as the company's anticipated cash flow, its existing leverage, its credit quality and the liquidity in the relevant markets.

Looking further ahead
As these are only temporary measures, and there are time limits on their use, consider what other steps should be taken in parallel or in the future

- **Existing facilities** – We have seen many companies draw down on existing facilities in recent days and it is likely that we will continue to see borrowers seeking to utilise their existing facilities to the fullest extent possible in the current environment. If a company wishes to draw down on existing facilities, it will need to establish whether there are any

drawstops that would prevent it from doing so. These might include material adverse change (MAC) clauses, suspension/cessation of business undertakings and financial covenants. Whether the COVID-19 pandemic constitutes a MAC will depend on the precise wording of the facility agreement, for example whether the MAC is framed by reference to the specific borrower or to the wider borrowing group. A company must also take care to ensure that any representations required to be given in connection with a drawdown of funds are truthful and accurate at the time it is given or deemed to be given. The inability to give a representation may prevent a company from drawing down on a facility. Covenants may need to be reset and other terms adjusted in order to avoid formal defaults. So far we have not seen a trend of banks seeking to block drawdowns and governmental pressure may mean that remains the case.

- **New and restructured bank debt** – Corporate loan markets remain active but, as credit risk increases and liquidity tightens, companies should expect the cost of debt to increase. Companies should think about their ability to service the debt in future, though banks may be willing to build in financial covenant holidays to address the impact of COVID-19 in the short term. Banks are however likely on the whole to be more cautious and seek greater controls over a borrower's business.

- **Debt capital markets** – The primary issuance markets for bond issues are largely closed for the time being but are likely to provide a source of funding in Q3 2020 once the situation has stabilised.

- **Debt restructuring** – For companies in severe difficulties, a debt restructuring may be an option in the longer term. This will require extensive negotiations and may require creditor and potentially shareholder approval.

Immediate steps

Identify existing facilities, and any obstacles to drawing down under them – and consider drawing down while available and possible

Think about any waivers or covenant resets that may be required

Plan how to submit utilisation requests / execute any necessary documentation in light of current and possible future restrictions on meetings and self-isolation

Monitor financial covenants and accuracy of representations and consider if any events of default have to be notified to lender(s)

Looking further ahead

Monitor adequacy of committed and uncommitted facilities and consider what would happen if uncommitted facilities are withdrawn

Identify any weak links in the group’s capital structure, for example whether one facility that has not been as robustly negotiated might result in a cross default

Consider whether a debt restructuring may be appropriate

As and when debt capital markets open up, consider a debt market issuance

CAPITAL CALLS

Another potential source of funding for a company is its shareholders.

For private companies, including joint ventures, there will be a range of issues to consider including the pre-emption rights that apply on new issuance, the timing and other procedural requirements for a new issuance and, where all parties are unable or unwilling to participate pre-emptively, any dilution of control and the impact on the regulatory position.

For public companies, equity capital raisings can take several forms and which one is appropriate is likely to depend in part on how much money the company is seeking to raise and how quickly it needs that money. Companies should aim to call on their shareholders only once – shareholders may be unwilling to co-operate with more than one fund raising exercise in the coming months.

In deciding which fund raising method to use, the factors to be considered will include:

- **Offering documentation** – In the EU a listed company wishing to issue shares representing more than 20% of its issued share capital must publish a prospectus. The preparation of a prospectus will take some time and may present particular challenges, for example because of the requirement for a prospectus to contain a statement confirming that the company has sufficient working capital for the next 12 months.
- **Shareholder approval** – For larger issuances, companies may need shareholder approval. With the current restrictions in place on gatherings and non-essential travel, that may be challenging, as well as having an impact on the timetable.
- **Investor guidelines** – Proxy advisers and institutional investors may have guidelines on which method is most suitable and what they are willing to support – the latest position should be checked.

In the short term, we may see and indeed have already seen a limited number of companies undertaking non-pre-emptive issuances through accelerated bookbuilt placings to raise smaller amounts of money.

Current market volatility and the need for a prospectus for larger fund raisings mean that we are unlikely to see more significant capital raises in the short term but we fully expect to see companies pursuing larger issuances later in the year.

We may also see the government stepping in and taking stakes in key strategic sectors, as happened with the banking industry at the time of the global financial crisis.

Immediate steps

For private companies, review equity documentation to identify funding provisions and engage with investors

Update financial model, business plans and budgets

For listed companies, consider whether to undertake a smaller issuance now or larger offer later in the year

Looking further ahead

For listed companies, start preparing any requisite offering documentation, such as a prospectus, to facilitate a larger issuance when the markets are right

INSURANCE

Companies should consider, as a priority, whether they have any scope to claim on any insurance policy, such as business interruption cover (particularly important now that there is widespread global lockdown, potentially triggering, if nothing else, enhancement covers such as denial of access or governmental closure) or trade credit or credit risk cover. It is important to note that, whilst insurance may have a role to play in providing relief to companies affected by the pandemic, it will not provide a complete solution.

Each policy should be read and scrutinised, as each will have its own terms and limits and exclusions. In particular, consider any bespoke cover. Where cover may be available, it will be important to ensure any notification requirements are followed carefully. Companies should also check the relevant policies for any loss mitigation requirements or insurer consent requirements.

If claims are made against the company, care should be taken to maximise protection under liability policies, such as employers' liability, D&O and public liability.

As well as considering what cover may already be available to the company, it is equally important to ensure that cover is maintained in future. Renewals may become more complex and early and effective engagement is key.

Immediate steps

Identify what policies may be claimed on and notify insurers, noting that the cover is complex and care should be taken to analyse exactly what is available

Be careful not to jeopardise any cover by taking steps where insurer consent or loss mitigation is required

Looking further ahead
Keep reviewing and assessing what cover may be available as governmental policy changes
Manage claims properly and diligently
Be alive to complexities in any renewals that come up

ASSET DISPOSALS

We were already seeing companies looking to dispose of non-core businesses ahead of the pandemic. This is likely to continue but a company looking to pursue an M&A transaction during this period of disruption needs to be aware of a number of issues:

- **Price discovery** – Few companies are unaffected by COVID-19 and many will be looking to preserve cash. As well as companies focusing on dealing with their own businesses, there remains uncertainty about when and where prices will stabilise. These factors mean that fewer parties are likely to be willing to join an auction or other sale process – which in turn may make it harder to establish and achieve a satisfactory price.

- **Acquisition financing** – Acquisition financing is, and is likely to remain, in short supply in the immediate future. This again may limit the number of potential purchasers on a sale process. At the same time, sellers are likely to want buyers to confirm that their financing is on a certain funds basis, given the issues with the potential for defaults and the need for covenant resets or waivers discussed above. The buyers which will be most attractive to a seller are those with readily available cash and fewest approval processes.

- **Practicalities** – Where there are restrictions on gatherings and non-essential travel, a seller may find it difficult to create a data room as it may be not be able to access the requisite documentation to populate the data room. Likewise site visits may not be possible and meetings with management are likely to have to take place online. Negotiations are also likely to have to take place remotely as face-to-face negotiations between principals, which typically are key to progressing a deal, may not be possible. Where parties and assets are in different jurisdictions, that will add an extra layer of complexity.

- **Possible obstacles to a transaction** – It will be important to assess from the outset any likely regulatory obstacles to a transaction. Anti-trust regimes will have to be navigated carefully given the fast pace of change – market shares may have changed in recent weeks as companies face collapse. However, where the alternative to a transaction is insolvency, it may be easier for certain buyers to make use of the "failing firm" argument in a merger control process, which if successful would result in a lighter touch and quicker competition review. As well as merger control issues and any regulatory or shareholder approvals, sellers must be mindful of any governmental restrictions that may apply. Many jurisdictions have the power to intervene in transactions on the grounds of national security. This concept is being interpreted very broadly, and includes transactions with a potential impact on public safety, public order or public health. We are already seeking these powers being stepped up, for example in Spain. The EU is urging member states to screen foreign direct investment into strategic industries under strain from COVID-19. Whilst the UK has not yet implemented its proposed new foreign direct investment regime, parties should not assume that it cannot or will not intervene – it issued 4 intervention notices on M&A transactions last year, compared with 8 in the preceding 15 years. More than ever, it will be important to navigate these potential hurdles carefully and explore the feasibility of remedies that could ease national security concerns.

Immediate steps

Start compiling a data room and undertaking vendor due diligence

Identify obstacles to a transaction, such as merger control or possible governmental intervention

Looking further ahead

Plan for the practicalities of completion, including arrangements for back up signatories if one falls ill and how to hold board and shareholder meetings

Carry out any pre-sale reorganisation and deal with any issues identified in due diligence

OTHER ISSUES TO CONSIDER

• **Directors' duties** – Directors will need to be mindful of their duties to the company, to shareholders, to wider stakeholders and, where relevant, to creditors. Some jurisdictions are considering relaxing the duties owed to creditors in the current disrupted climate but it is unlikely that directors' duties will be suspended. It is essential that the whole board is involved in discussions around any solvency issues.
• **Executing documents** – Where documentation has to be signed, there may be logistical issues, for example in getting a document witnessed. Early planning will be key.
• **Inside information** – Companies listed in the UK or EU must remember their obligations under the Market Abuse Regulation (MAR) to announce any inside information. Whilst delay is permitted in certain situations, a company cannot delay disclosure of financial difficulties, even if it is in negotiations which may help remedy its position.
• **Ongoing obligations** – Companies should not forget their "business as usual" obligations, for example around notification of PDMR dealings under MAR, filing accounts by the requisite deadline (or applying for an extension if permitted and needed) or renewing insurance policies.

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

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