

LATAM Market Development: Covid-19 and Its Implications on Private Sector Credits

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The recent outbreak of novel coronavirus (also known as COVID-19) has had devastating effects since the first cases were reported just over three months ago. As you are aware, the severity of the outbreak combined with the impact of responsive measures implemented by a number of governments, including shut downs, has caused significant disruption to most businesses operating in Latin America. To date, companies have drawn down on committed lines of credit and reduced operating expenses. The next phase may be companies having to approach their lenders and financial investors for relief of one sort or another. We thought it would be helpful to highlight some of the key issues that we are seeing across credits in the region.

Possible Events of Default

- **Admission of Inability to Pay Debt:** Although included in most debt documentation in one form or another, the precise meaning of this clause is not well settled under New York law. On the one hand it is clear that for this event of default to be triggered, market rumors alone about the inability to pay debt are not sufficient and that some reasonably clear general admission by the company is required to trigger a bankruptcy event of default. In thinking about whether a bankruptcy event of default has been triggered as a result of statements made by an issuer about its liquidity or intentions, investors should focus on the specific wording of the event of default and the nature of the statement.

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The wording of this clause varies among credits, requiring a written, public or any admission or just a general condition of inability to pay debts as they become due, and often requires an inability to pay debts generally and not just specific debts or payments.

- Expropriation and Adverse Actions: Expropriation events of default and prepayment triggers could be implicated by certain measures taken by governments. In some jurisdictions, laws have been enacted authorizing the government to expropriate facilities of private parties to be used for purposes of combating the COVID-19 outbreak. Elsewhere, governments have closed critical infrastructure to combat the spread of the outbreak. In the event such measures are effectively taken and were to impact an issuer, it may trigger potential rights of creditors (to call an event of default, or a mandatory prepayment if the issuer receives consideration). The measures could also trigger rights of issuers (i.e., to bring claims against the government for impairing their use of an asset), including under bilateral and multilateral investment treaties.

Reliance on Impossibility, Force Majeure and other Defenses to Payments

- Parties who are or may be unable to perform their obligations as a result of the epidemic may look for a means of suspending or exiting a contract, or a shield from liability via force majeure clauses in their contracts.
 - *Operating Contracts*: In operating contracts, force majeure clauses and the doctrine of frustration may excuse non-performance. In evaluating credits, it will be important to evaluate whether the issuer's liabilities can be excused pursuant to these doctrines – and also whether the obligations of suppliers and customers to an issuer could be excused. Many issuers will face difficult issues in sharing information with the markets about this topic, having to balance the potential advantage of

being candid with investors against their legal strategies.

- *Debt Contracts*: Indentures and credit agreements generally do not include force majeure clauses. Some issuers have recently raised the possibility of using an “impossibility” defense to be excused from payment obligations. New York courts have interpreted and applied such defenses very narrowly, holding that these defenses would generally be applicable only in cases where circumstances made it impossible for an issuer to make payment (either by cash, check or wire transfer) rather than circumstances impairing liquidity.

Financial Ratios and Tests

- Indentures and credit agreements handle financial ratios differently. Indentures typically have incurrence covenants, in which covenants are not breached by a deterioration in financial conditions except where the issuer seeks to incur new obligations or fails to make payments. Credit Agreements, on the other hand, typically have maintenance covenants that require the maintenance of certain ratios with the objective of monitoring the financial situation of the debtor. Both indentures and credit agreements ratios often have “baskets” that are defined with reference to balance sheet metrics, such as asset values, and some credit agreements have “net worth” tests that are balance-sheet based.
 - *Financial Ratios*: It is important to evaluate how accounting rules could impact EBITDA-based ratios in situations where substantial amounts of revenues may be recognized in the income statement notwithstanding that they may not reflect concurrent cash inflows. In addition, parties should review the definition of EBITDA in their credit documents to identify potential addbacks that may be utilized to limit the covenant impact resulting from reductions to net income or EBITDA as a result of the outbreak, including addbacks related to

unusual, non-recurring or exceptional expenses, losses, costs or charges.

- *Balance Sheets*: Creditors should be aware that the drop in market prices as a result of the crisis may lead to significant impairments on balance sheets. These impairments may restrict access to balance sheet-sized baskets, and could also lead to deterioration in net worth metrics.

Impacts on Ability to Comply with Covenants

The potential impacts of COVID-19 on the business of issuers may result in the inability to comply with covenants in the relevant debt documentation. Bondholders should also be aware of the relevant terms and applicable carve outs of the covenants to be able to map out the actions the issuer will still be able to take.

- **Reporting Requirements**: Given the shutdowns and social distancing policies in several jurisdictions, it is possible that the company auditors may not be able to perform the diligence and audit procedures that would be necessary to timely prepare the financial statements that are required to be delivered pursuant to the indenture, or that shareholders meetings to approve financial statements may need to be deferred. In addition, the market crisis will likely raise difficult impairment questions that may affect the timing of financial statements.
- **Maintenance of Insurance**: Many credit agreements include a covenant that obligates the issuer to maintain insurance with respect to its business and properties. Given the impacts that COVID-19 may cause in the insurance market, you should consider that the issuer may face difficulties in maintaining the required insurance coverage.
- **Limitation on Indebtedness**: Many governments are extending survival loans to companies, but it is possible that debt covenants may prevent the companies from accepting them. Credit documents may include carve outs related to

borrowings from development banks or government-sponsored agencies or borrowings for purpose of financing employee compensation, social security benefits or severance payments, but these exceptions are not consistent among credits and the wording varies greatly among credits that do benefit from them.

Additional Considerations

- **Creditor Meetings**: The COVID-19 outbreak has caused several governments to impose shutdowns or quarantines, as well as social distancing, which could prevent the occurrence of in-person meetings. This could have an impact in jurisdictions that require bondholder meetings to be held in person. In some jurisdictions, creditor meetings in a bankruptcy context must also be held in person, and courts have either suspended such meetings or authorized, when requested, that they be held virtually as a result of COVID-19.
- **Actions by Holders; Trustee**: As the pace of restructurings picks up, creditors should bear in mind the roles played by trustees and agents. Typically, indentures include “no action” provisions that require bondholders to take legal action against the issuer through the trustee. In the event the current trustee or agent does not act quickly or efficiently enough, creditors may need to consider replacement. Credit documents may vary with respect to their requirements for replacement of trustees and agents, and as such, you should take note of the relevant provisions to be able to plan such replacement. Some indentures give rights to “holders” defined as registered holders whereas others include a definition of holders that would permit beneficial owners of those securities to act. In the former case where holders are defined as registered holders, it may be more difficult and/or time consuming to take action given the need to involve DTC or Euroclear and participants in the clearing system and parties considering action should take that into account when considering the timing of taking action.

- Forbearance: While amendments and waivers to the payment provisions of most indentures require unanimous consent of holders, some debtors may seek forbearance arrangements regarding specific payments from holders, where significant majorities can be easily identified, in order to mitigate the risk of acceleration and enforcement and gain time to reorganize their businesses. While indentures would not prohibit individual holders from seeking payment, forbearance arrangements could significantly reduce the enforcement risk to debtors. It is important to note that although a forbearance will mitigate enforcement risks, it does not cure or prevent a “default” from happening.
- Antitrust: In certain jurisdictions, when creditors enforce on equity pledges, the enforcement may trigger antitrust filing requirements. In light of broad shutdowns of government agencies in many jurisdictions, creditors should carefully plan out any strategy related to antitrust filings or opinions that may be required.

The COVID-19 crisis continues to be a dynamic situation, and we anticipate that other issues relating to credit will continue to arise. We encourage you to contact us if you would like further information on these, or other issues.

We also encourage you to consult our resources on COVID-19 at [COVID-19 Resource Center](#), as well as our more recent pieces on Latin American restructurings and credits at [The Emerging Markets Restructuring Journal](#).

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