

CORONAVIRUS: LEVERAGED FINANCE – KEY CONSIDERATIONS IN RESPECT OF DELAYED AUDITS AND REPORTING COVENANTS

The Coronavirus (Covid-19) pandemic has coincided with a critical time in the financial reporting cycle for many companies. Those with a 31 December financial year-end and who have not completed their audits are likely engaged in their audit process now, and those with contractual reporting obligations will likely need to submit their annual audited financial statements within the next few weeks. Given the disruption caused by the Coronavirus, however, many year-end audits presently are not able to be completed, due to, inter alia, the impossibility of physical meetings between audit committees, auditors and management, difficulties obtaining internal control evidence and carrying out audit procedures due to social distancing measures and travel restrictions, and issues related to post-balance sheet date changes in business operations. In the United Kingdom, for example, the Financial Reporting Council has advised that "additional time may be required to complete audits and it is important that this is taken, even at the risk of delaying company reporting."

Various regulators across the globe have recognized this issue as well and have provided relief from reporting requirements for public issuers. The U.S. Securities and Exchange Commission (SEC) has granted relief from filing annual financial reports for the time period from 1 March 2020 to 1 July 2020. In the United Kingdom, the Financial Conduct Authority has extended the deadline for reporting annual audited financials by two (2) months, and the European Securities and Markets Authority in Europe has done the same for companies in the European Union. Similarly, the Securities and Futures Commission and the Stock Exchange of Hong Kong have also extended the deadline for issuers to publish annual reports by 60 days and have indicated that a further extension may be warranted. This regulatory response, however, only provides relief in respect of public reporting obligations, but many companies are subject to contractual reporting requirements as a result of their private finance contracts, including, for example, high-yield bond indentures and leveraged loan agreements.

Key issues

- Social distancing requirements and material changes in the commercial environment, among other things, may prevent auditors from completing their audit procedures and thereby inhibit companies from being able to provide audited financial statements and complying with their reporting obligations
- Companies facing likely delays should consider their status and audit timelines and engage with stakeholders as quickly as possible

This briefing will focus on some of the key considerations for high-yield bond issuers and sub-investment grade loan borrowers when faced with Covid-19 related audit delays, which vary from those experienced by companies with other financing arrangements, such as investment grade or convertible securities, due to differences in documentation and market practice.

REPORTING COVENANT COMPLIANCE

While reporting covenants vary significantly and we stress that each reporting company needs to review the details of its specific covenants and the related exceptions and qualifications, reporting companies need also to consider their particular situation and the nature of their lending or bondholder groups as well as where in their audit and reporting process they were when an interruption occurred in order to determine where they stand from a contractual compliance perspective. For reference, however, a sample of a typical reporting covenant from a high-yield indenture is formulated as follows:

"within 120 days (or 150 days for the Issuer's first fiscal year ending after the Issue Date) after the end of the Issuer's fiscal year beginning with the first fiscal year ending after the Issue Date, annual reports containing, to the extent applicable, the following information: (a) audited consolidated balance sheets of the Issuer or its predecessor as of the end of the two most recent fiscal years and audited consolidated income statements and statements of cash flow ..."

It is the compliance with this type of reporting covenant that may prove challenging for some companies as a result of Covid-19 related disruptions.

While the specific facts around the Covid-19 pandemic are unique, companies have faced difficulties in meeting their reporting requirements previously as a result of unanticipated and unprecedented events, such as during the collapse of Arthur Andersen and during the Great Recession as well as in situations specific to individual issuers. For example, when issuers audited by Arthur Andersen were unable to complete their annual audits in April 2002, the SEC issued an order allowing companies to publish initially only their unaudited year-end financials and then subsequently amend their filings within 60 days with their audited financials.

Likewise there is some case law relating to interpretations of reporting covenants in the context of delays in providing information, but the fact patterns in those cases do differ materially from the current circumstances. Previously, for example, reporting covenants in many indentures were triggered off of and related back to SEC reporting requirements, and the provisions of the Trust Indenture Act of 1939, as amended (the TIA), and courts, such as the Eighth Circuit Court of Appeals in *UnitedHealth Group Inc. v. Wilmington Trust Co.*, linked an issuer's obligations under its reporting covenant to this independent regulatory requirement. Today, however, this formulation is uncommon in the United States for issuers that are not otherwise SEC reporting companies and is rarely seen in the European or Asian markets given references to SEC filings and incorporation of TIA provisions do not exist in most indentures in those jurisdictions. Instead, the current, predominant formulation is as per the above and consists of a specific reporting deadline in an indenture, loan agreement or similar contractual arrangement, which generally requires a company to provide annual audited financial reports within 120 days of the end of a company's fiscal year (though in some instances this requirement may take effect as early as 90 days or as late as 150 days following a company's fiscal year). Typically, however, there

are no qualifications or exceptions to the reporting timeline and no contractual "outs" from compliance with the specific deadline to report.

In the event a company fails to provide such audited financial statements within the timeframe specified in the reporting covenant, the company has breached the reporting covenant. Depending on the interpretation of the specific contract, there may be a grace period within which this breach may be cured before it becomes an event of default, and even after it becomes an event of default it may be capable of being subsequently cured. Once there is an event of default, this would allow the trustee, agent, noteholders or lenders, as applicable, to accelerate the notes or loans and declare all outstanding principal and unpaid interest immediately due and payable.

Given the serious consequences of a default, high-yield bond issuers and sub-investment grade loan borrowers must consider their options if faced with the likelihood that, due to the market and audit disruption caused by the Covid-19 pandemic, they will be unable to provide the necessary audited financial statements in time to comply with their obligations under their reporting covenants.

KEY CONSIDERATIONS FOR COMPANIES ANTICIPATING REPORTING DIFFICULTIES

As noted, bond and loan documentation varies, but key for leveraged finance issuers and borrowers across both products is attention to the specific wording of the finance documents as well as early stakeholder engagement. For instance, while in general bond and loan reporting covenants are conceptually consistent within their respective domains, the particular details, timelines and carve-outs provided in a given reporting covenant are negotiated for each issuer or borrower and therefore require an analysis carefully tailored to the individual company when contemplating its response to anticipated difficulties in meeting its reporting obligations. Timely and considered engagement with stakeholders is also critical, particularly for companies that have already communicated a reporting schedule (or have established a market expectation of a particular reporting timeframe) which they anticipate being unable to meet.

- **High-Yield Bond Documentation:** The path forward for affected bond issuers is potentially the most challenging: New York law governed high-yield bond indentures have historically approached amendments through consent solicitations, which can prove difficult, time consuming and potentially expensive for bond issuers. As a result, bond issuers should consider if they have a reporting or compliance option available that would permit them to proceed without engaging in a consent solicitation. For example, some issuers are considering whether to supply unaudited financials in the event audited financials are not available, which was done as a mitigation measure in the UnitedHealth case. Furthermore, some issuers are considering the argument as to whether they may be able to argue the Covid-19 pandemic constitutes force majeure and thereby excuses their inability to provide audited financial statements. Some issuers will, however, want the certainty that come with a specific consent and will engage in a consent solicitation—these issuers should commence that process as soon as possible and we would expect that noteholders should be responsive and supportive to reasonable waiver requests in light of the current circumstances.

- **Loan Documentation:** The situation for loan borrowers is likely more straightforward. Borrowers anticipating being unable to comply with their reporting obligations can seek a waiver from their lenders. While the ease of obtaining such a waiver may vary according to how broadly syndicated a particular loan is—with a Term Loan B likely proving more challenging than more closely held club and private debt deals—experience suggests lenders should efficiently accommodate such requests.

Irrespective of which leveraged finance documentation applies, in the event a company believes it could be impacted by a delay in the completion and availability of its audited financial statements, the company should address the issue as quickly as possible.

In addition to the considerations discussed above, companies should also consider the format and timing of their communication to stakeholders as well as whether or not they should provide any unaudited financial information, similar to the approach taken in the *UnitedHealth* case.

Furthermore, companies (including those that have already completed their audits) should bear in mind that the current Covid-19 pandemic has other implications in respect of the preparation of other financial information, for example:

- **Future Securities Issuances:** For companies that are considering the issuance of securities in the near term, the same issues that are causing the inability for some companies to complete their audits are also causing significant challenges for auditors to provide customary comfort letters for new securities offerings. As such, we believe that addressing the ability of auditors to issue customary comfort letters and any limitations of or changes from the traditional procedures related thereto should be identified at the beginning of any transaction.
- **Other Legislation:** Finally, while this briefing does not address the subject, companies should also consider their obligations under other reporting regimes, such as the European Market Abuse Regulation and insider trading regulations more generally, particularly regarding price sensitive information, with respect to the delayed release of their audited financial statements.
- **Future Reporting Covenants:** When negotiating future reporting covenants, consideration should be given as to whether it is appropriate to incorporate qualifications or extensions to reporting periods in the event that applicable governmental or regulatory authorities extend filings for listed equity due to market or other disruptions. Such a provision would be akin to the earliest formulations of high yield reporting covenants which originally were based on statutory reporting periods and thereby subject to any extensions that the SEC may grant.

Our "Coronavirus: Leveraged Finance – Immediate Financing Considerations for Financial Sponsors, Underwriters and Debt Investors" briefing and other Coronavirus (Covid-19) materials can be found here:

https://www.cliffordchance.com/insights/thought_leadership/coronaviruses.html

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