

## MANAGING FINANCIAL COVENANTS FOR HEALTH CARE BORROWERS IN A PANDEMIC

COVID-19 has caused substantial volatility in health care systems' finances. The suspension of elective procedures has drastically reduced provider revenues, while expenses have generally been reduced only slightly. Government relief programs may help offset lost revenues, but for most providers, the net impact is expected to be negative.

For health care systems with outstanding debt, whether publicly issued or privately placed, it is important to know what financial covenants are in your debt documents and to have a plan for what to do if you are in danger of tripping one or more of them. These covenants are most often found in a Master Trust Indenture ("MTI"), in supplemental master trust indentures, and/or in credit agreements with banks.

The most common financial covenants are (a) **a minimum required debt service coverage ratio ("DSCR")**; and (b) **a liquidity requirement, generally expressed as days' cash on hand**.

For each financial covenant, the key factors to consider are (1) the likelihood of violating the covenant (which depends both on the strictness of the test, and the measurement period); (2) to whom the covenant has been made; and (3) the consequences of violating the covenant.

### LIKELIHOOD OF VIOLATING COVENANTS

The likelihood of violating either a DSCR covenant or a liquidity covenant depends in part on (a) how strict the covenant is; and (b) the measurement period of the covenant.

For example, the minimum required DSCR often ranges from 1.10 to 1.25, while days' cash on hand covenants often range from 40 to 80 days. Borrowers are more likely to violate a more strict test in times of financial stress than a more lenient one.

In addition, the applicable measurement period, and the specific date of testing may substantially influence the likelihood of a covenant violation. Quarterly covenant measurement periods, tested following the end of each quarter, will be far more likely to cause a covenant violation than annual testing. Even for an annual test, the timing may make a real difference. An annual test for a fiscal year ended December 31, 2020 may be more or less likely (depending upon the severity and length of COVID-19 effects) to trigger a covenant violation than an annual test for a fiscal year ended June 30, 2020. In addition, most annual tests are based on annual, audited financials, which may take 120-180 days after the close of the fiscal year to complete. Quarterly tests are generally based on internally prepared financial statements and are often due within 45-60 days after the end of the quarter.

### TO WHOM THE COVENANT HAS BEEN MADE

Publicly offered bonds will generally only be subject to the covenants contained in a borrower's MTI, or if they do not have an MTI, in the related Bond Indenture and/or Loan Agreement. These covenants are often more lenient than those required by bank holders, but due to the nature of publicly traded securities, if a default has occurred, or is imminent, identifying the holders of the debt and obtaining a waiver of default is generally difficult.

In contrast, bonds that have been privately placed with banks and other obligations under bank credit agreements often have more stringent financial covenants than those contained in a borrower's MTI but also allow for the possibility of working directly with a bank to discuss potential covenant defaults, remedies and waivers.

If a covenant has been violated and a waiver is unavailable, or if a holder is unwilling to waive the violation of the covenant, then the question becomes how far does the damage spread.

### CONSEQUENCES OF COVENANT VIOLATION

***Not every covenant violation immediately triggers an event of default.***

Frequently, if the reported DSCR is below the covenanted level, but above 1.00:1.00, or if days' cash on hand drops below a certain level, the proscribed remedy is a "consultant call in." Generally, the consultant will deliver a report as to how the borrower can increase revenues

or decrease expenses, thereby improving its DSCR or days' cash on hand. Many MTIs provide that such recommendations need not be followed if the consultant concludes that the inability of the borrower to meet its financial covenants is due to applicable laws and regulations, or that the fees and rates charged by the borrower generate the maximum income likely to be achieved. In some MTIs, so long as the borrower follows the recommendations in the consultant's report, no event of default will occur. In others, and in many bank documents, an event of default will be avoided only if the borrower both (1) follows the recommendations of the consultant; and (2) maintains a DSCR at or above 1.00:1.00 and/or days' cash on hand above a certain level.

However, if a borrower's failure to meet a financial covenant triggers an immediate event of default (such as if the DSCR falls below 1.00:1.00, or if days' cash on hand falls below a minimum level) AND if the borrower cannot obtain a waiver, either because the debt is held by too many holders to make a waiver practical, or because a bank is unwilling to provide a waiver, then the concern becomes if such default will trigger defaults on other debt. Whether and if the event of default triggers "cross defaults" on other debt depends on where the defaulted covenant resides and how the other debt documents have been drafted. For example, it may be that the covenant is isolated to a particular bank credit agreement and will not cause a default under other debt documents of the borrower. On the other hand, many credit agreements contain cross-default provisions, whereby a default under one debt instrument will automatically trigger a default under others. If the defaulted covenant is in the MTI itself, or in a supplemental master trust indenture, then, generally, a default of such covenant will trigger a default under ALL of the borrower's debt secured under its MTI, and oftentimes other bank debt as well. This generally causes all outstanding debt to become immediately due and payable, with obvious negative financial repercussions.

For this reason, understanding if a covenant violation is likely, and if so whether such violation can be isolated, is an important consideration for borrowers when evaluating their actions and operations, even in a pandemic.

## WHAT YOU CAN DO

Finance departments should be aware of their various financial covenants, and monitor them closely. If there is any possibility of default, borrowers should act proactively, speaking with counsel, and the holders of bank-placed debt and/or credit banks, preparing them for the potential covenant violation and proactively considering remedies. If a consultant-call in is likely, determining what consultant a borrower would like to use in advance is advisable.

## HOW WE CAN HELP

- **Debt Covenant Review.** Hall Render can perform a low-cost review of the scope and scale of a borrower's financial covenants as well as the implications of default.
- **Proactive Assistance.** Hall Render can help borrowers communicate with banks and with the public markets regarding their current financial situation, whether or not a default is likely.
- **Consultant Call-Ins.** Hall Render and Hall Render Advisory Services can help identify and engage qualified consultants if a consultant call-in is required.
- **Rebuild and Restore.** Hall Render can assist clients in considering strategies to repair and restore their financial situation including the re-structuring of existing debt, the pursuit of federal and local financial assistance, the monetization of real estate assets and more.

For more information about the content detailed above or any questions related to this matter, please contact:

- **Ron Sheff** at (443) 951-7042 or [rsheff@hallrender.com](mailto:rsheff@hallrender.com);
- **Bobby Hamill** at (919) 447-4970 or [rhamill@hallrender.com](mailto:rhamill@hallrender.com); or
- Your regular Hall Render attorney.

Special thanks to Marina Allen, law clerk, for her assistance with drafting this article.

Hall Render's attorneys and professionals continue to maintain the most up-to-date information and resources at our [COVID-19 Resource page](#), through our 24/7 COVID-19 Hotline at (317) 429-3900 or by contacting your regular Hall Render attorney.

*Hall Render blog posts and articles are intended for informational purposes only. For ethical reasons, Hall Render attorneys cannot—outside of an attorney-client relationship—answer specific questions that would be legal advice.*