

# Liquidity solutions for businesses weathering the COVID-19 crisis

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The COVID-19 pandemic raises liquidity concerns for businesses across industries, threatening the immediate and long-term health of many companies and the economy more broadly. While most companies usually have some degree of liquidity protection in place, today's highly volatile business climate will mean, in many cases, that such arrangements are inadequate, or are at risk of not being available as anticipated.

We explore the options that may be available to businesses to address their liquidity needs in the wake of the crisis, together with key compliance and other considerations.

Liquidity is a measure of a company's short-term assets (such as cash, short-term investments, receivables and inventory) available to meet short-term obligations. The COVID-19 pandemic potentially impacts both sides of the equation: it can adversely affect short-term assets (including the collectability of receivables), while also raising near-term expenses, including, for example, the costs of transitioning to a remote work force, keeping employees safe and workplaces operational, and downsizing costs.

## Approaches to address liquidity

### Borrow from existing debt commitments

Typically, the most readily available source of liquidity is to draw down unfunded, committed revolving credit facilities. These revolvers come in two basic variations: cash flow revolvers and asset-based loans (or ABL). A company can borrow the full amount of the lenders' commitments, subject to covenant compliance, under a cash flow revolver, while the amount that can be borrowed under an ABL revolver is limited by a borrowing base. The borrowing base is calculated based on the value of certain of the borrower's liquid assets; these typically include receivables and inventory (or, for example, in the case of the oil and gas industry, reserve value).

We have seen a number of borrowers draw their cash flow revolvers in whole or in part over the past several weeks to bolster liquidity. We have also seen significant borrowings under ABL credit facilities, but these facilities have generally not been fully drawn, due to the borrowing base constraint and because these facilities typically include undesirable additional restrictions (such as triggering additional financial maintenance covenants and a loss of control of cash movements from a borrower's bank accounts) if unused revolver availability falls below a specified threshold.

## Satisfying conditions to availability

Most lenders seem to be approaching liquidity situations constructively and continue to honor revolving and other loan requests. However, in this environment, it is important for a borrower to confirm it can satisfy all conditions to availability under its revolver. While many of these conditions will be straightforward, others are more subtle. For example, most revolvers require representations and warranties to be refreshed upon drawing, including a representation that no event has occurred that has had, or is reasonably be expected to have, a Material Adverse Effect (or MAE).

The specific formulation of this representation and the definition of MAE can vary from agreement to agreement, and it is important for borrowers to review those details with their legal advisors. As a general rule, courts have set a fairly high threshold for determining whether an MAE has occurred and require that the impact of the event both be significant in magnitude and duration (read our complete analysis on COVID-19 and MAE clauses [here](#)).

Accordingly, lenders have been reluctant to refuse funding revolving loans due to a disagreement over whether or not an MAE has occurred. As noted above, many revolvers have been accessed recently notwithstanding the need to make a no-MAE representation. However, because the impact of the COVID-19 epidemic varies from one borrower to another, is in many cases severe, and is rapidly evolving, it remains to be seen whether more companies lose access to their revolvers due to an inability to bring down this representation going forward.

Many companies are deciding to draw down now and keep cash on their balance sheet, rather than risk an adverse MAE determination at a later point. Borrowers will need to verify whether their revolvers have limitations on the ability to draw down funds for no specific purpose (often referred to as anti-cash-hoarding provisions).

While less common in the United States, many mid-market Canadian credit agreements also contain an event of default triggered by the occurrence of an MAE. A lender would typically have a right to accelerate existing loans and enforce other remedies upon an event of default. Lenders have typically been cautious about exercising remedies based solely on an MAE absent other breaches. We will have to see if the same approach continues as lender sensitivity increases while the duration and severity of the crisis grows, but the likelihood of other defaults (see below) will reduce the need for the MAE default to be tested.

Because revolvers invariably include, as a condition to borrowing, the absence of any default (before and after giving effect to the advance), borrowers should closely monitor their compliance with credit agreements to ensure access to committed facilities. Borrowers must therefore continue to strictly comply with the requirements of any credit agreement, and not put themselves in a position where lenders can decline funding commitments over relatively minor non-compliance, such as technical reporting obligations.

## Satisfying financial maintenance covenants

One key area of compliance concern will be the financial maintenance covenants contained in many credit facilities (both revolvers and term loans), which require certain financial tests to be maintained as measured at the end of a particular financial period.

For example, many agreements specify a maximum leverage ratio which is measured, as of the date of determination, as a ratio of debt (in some cases reduced by cash on hand) to earnings before interest, taxes, depreciation, and amortization (or EBITDA) for the last twelve-month (LTM) period.

As borrowers typically need to satisfy their financial covenants both before and after giving effect to an advance in Canadian facilities, these covenants may restrict their access to additional credit. Given the trailing nature of the EBITDA calculation, the impact of COVID-19 on financial covenant calculations will trail the actual business slowdown, impacting calculations for a full year, even if the reduction in business proves to be relatively short. Financial covenants may also be subject to equity cures for borrowers with a private equity sponsor.

As discussed in our [COVID-19: M&A considerations](#) guidance, credit facility EBITDA definitions vary widely, but borrowers may be able to add back expenses related to the COVID-19 epidemic as non-recurring, unusual or extraordinary expenses or restructuring expenses. Costs of this nature may, however, cease to be eligible if the effects of COVID-19 last for an extended period and these costs become permanent, regular costs of doing business in a changed environment.

While addbacks to EBITDA for unusual expenses may be helpful, their benefit is likely to be dwarfed by lost revenue resulting from the pandemic. Generally, lost revenue cannot be added back to EBITDA. Accordingly, we have begun to see what will likely become a wave of credit agreement amendments and covenant waivers in the months ahead as earnings decreases are projected to flow through LTM EBITDA.

Such amendments are typically negotiated in the context of revised projections for the business presented by the borrower. However, it is difficult, if not impossible, for many companies today to make meaningful predictions about short- and medium-term revenue. As a result, lenders and borrowers are likely to agree on covenant relief for short periods to allow business conditions to stabilize and for meaningful projections to become available.

It is not uncommon for borrowers (particularly in the U.S. market) to have “covenant lite” facilities, which do not contain financial maintenance covenants. Even these agreements, however, will inevitably be affected, as many permissions allowing a company to effect transactions (such as borrowing more secured or unsecured debt, selling assets or making acquisitions or other investments) are subject to satisfaction of financial tests.

## Secure new debt commitments

Another method of boosting liquidity is obtaining new debt commitments. While it will be difficult for some borrowers to obtain new credit lines in a challenging debt environment, we have already seen several companies that have been severely hurt by the pandemic—as well as others that are being proactive and cautious—obtain new “liquidity” lines to help tide them over.

Additionally, some investment-grade issuers have accessed the bond market, tapping into investor demand for lower-risk investments. Some of these issuers have used proceeds of long-term debt to reduce short-term obligations (such as maturing commercial paper), which helps liquidity by reducing obligations maturing in the near term.

We are also seeing many investment-grade borrowers leverage their relationships with banks to access shorter-term bilateral credit facilities, in the form of term debt or revolvers, to ensure sufficient liquidity through the COVID-19 pandemic crisis. Typically, pricing for these facilities will not be as favourable as a borrower’s existing corporate revolvers.

While the market for new high-yield note issuances has closed for the time being, private sources of debt capital may still be available to sub-investment grade companies, albeit at higher cost and with possibly more restrictive terms than were available before the COVID-19 pandemic.

## Other sources of liquidity

When facing liquidity issues, borrowers should also consider sources beyond debt financing to satisfy liquidity demands. One option is to sell assets. In each case, borrowers should carefully consider whether such sales are permitted under their existing credit agreements and indentures and, equally importantly, whether these agreements require that any sale proceeds be applied to repay debt, leaving the borrower no further ahead from a liquidity perspective.

Sales of long-term assets to boost liquidity may help an immediate liquidity issue, but reduce the company’s ability to generate revenue down the road, and so may be shortsighted.

Sales of equity may also be an option to provide liquidity. While public equity markets seem shut down (at least temporarily), private sources of equity may be available, albeit often at a higher cost than debt. Borrowers should again review existing debt documents to determine whether there are any requirements to repay debt with equity proceeds, although lenders may well be willing to waive any such requirement to allow an inflow of capital to the borrower that is junior to the lenders’ claims.

As the COVID-19 crisis unfolds, strategic options, including mergers, joint-ventures and spin-offs, are likely to increasingly come into play in response to persistent liquidity and other financing problems.

Finally, government support programs are likely to provide significant additional sources of liquidity. While some of these programs have already been announced, we expect that there will be more to come as governments assess the widespread impact of the pandemic and the broad need for enhanced supports in order to mitigate damage to the

overall economy.

**Read all our coronavirus-related updates on our [COVID-19 guidance for organizations](#) resource page.**

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