Leveraged Finance

The legal drivers and pitfalls when handling an impending financial covenant breach

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What this note covers

A forecast breach of a financial covenant is often an early warning sign that a business is not performing to plan. Unless self-help remedies are open to the borrower, lenders will have an opportunity to 'get around the table' and have their say on what happens next. The current macro-economic and interest rate environment is resulting in an increase in PE-owned businesses finding themselves in this situation.

If the company is to continue as a going concern (and absent a refinancing, sale or other transaction), it will need a waiver or a covenant re-set. If and how it achieves that will depend on the circumstances surrounding the company.

The '**if**' will depend, ultimately, on the willingness of the sponsor and/or lenders to support the company. This will be determined by the usual myriad of factors that inform credit and investment decisions, and in some cases 'left field' events.

The focus of this briefing is on the '**how**' in the critical period before an Event of Default occurs (sometimes called the 'pre-contractual' phase). We look at the technical and practical points that every borrower and lender will want to know and consider when facing a possible breach.

Sections

Section 1

Typical testing regime: tests & timing

What are the most common tests?

- **Leverage covenant**: a test of debt to EBITDA designed to indicate if the borrower has sufficient operating profit to repay its debt. Breaches often occur where financial performance has not met agreed financial projections as set out in the company's base case model, resulting in the ratio of debt-to-EBITDA being higher than the lenders bargained for.
- **Cashflow cover covenant**: usually a requirement of amortising facilities, this is a measure of the business' cash generation available to service its debt (interest and principal). Cashflow derives from EBITDA, so a downturn in earnings and/or the business incurring unexpected cash outflows (or additional debt, where permitted) may lead to a breach of this covenant.
- **Interest cover covenant**: a test of earnings relative to interest costs based on a ratio of EBITDA to finance charges, which seeks to assess the borrower's ability to service its borrowing costs from its operating profit. Recent increases to base rates will have made this test harder to satisfy for most businesses**.**

Self-help option: equity cure

An equity cure provision allows the sponsor to inject additional capital to 'cure' a financial covenant breach and avoid an Event of Default.

Equity cure is a pure option on the sponsor's part. Depending on the circumstances, a sponsor may prefer to seek concessions from the lenders (and perhaps other stakeholders such as management) in return for injecting new monies.

Where a borrower is aware of a potential breach before the test date (and to the extent allowed under the finance documents), the sponsor may inject equity to be used as an add back in calculating the relevant ratio prior to the breach.

A borrower usually has 10 to 15 business days after reporting a breach to elect to use the equity cure and a further 10 to 20 business days to procure that the sponsor injects the cash.

When are they tested?

Typically, **testing occurs quarterly using numbers for the previous 12-month period**. In special situations, testing may be monthly (usually only the case when the business is in 'turnaround' already).

Critically, although the calculations are made on the specified test date (usual quarter days in most cases), the **testing of the covenant as between borrower and lenders does not occur unless and until the borrower reports to the lenders**.

A borrower will typically have **30 or 45 days to report to the lenders** on the outcome of the test, and will be obliged to do so by delivering a Compliance Certificate and supporting calculations alongside the relevant financial statements.

Most facility agreements provide that the **test is undertaken by reference to the Compliance Certificate and the relevant financial statements**. So, if a borrower does not deliver a Compliance Certificate, there can still be a breach of the financial covenants as a matter of contract if the breach can be deduced from the information in the financial statements.

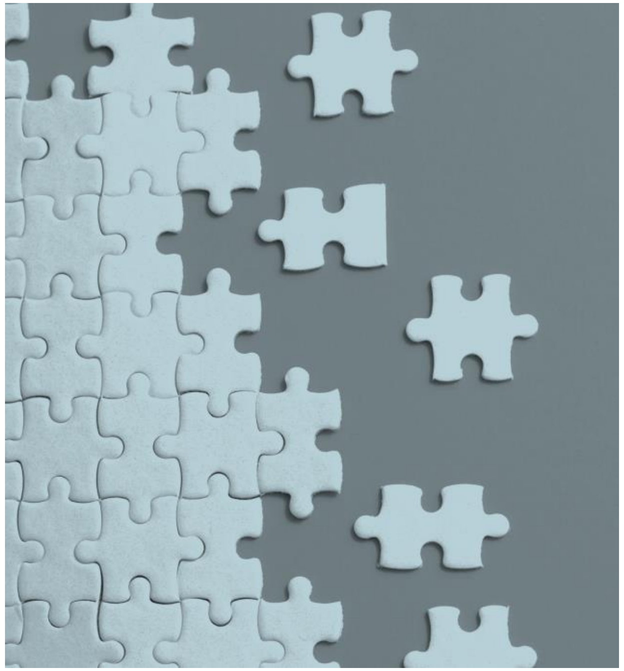
Financial covenant breaches, once reported, will generally cause an immediate Event of Default, giving lenders the right to accelerate (demand immediate repayment, cancel their commitment, instruct a Security Agent to enforce security, etc). The only qualification to this, other than standstill periods in favour of junior lenders (in the intercreditor agreement), will be if there is an equity cure provision.

Section 2

Common legal drivers and pitfalls

Lenders will want to know as soon as possible about a forecast breach. A borrower and its sponsor will want to work out their own position before they alert the lenders.

The time available to a borrower and its sponsor to agree on the way forward (often referred to as its “runway”), and any proposal for the lenders, will depend on all the circumstances. Common legal drivers and pitfalls are as follows.



When exactly will the default occur	Delaying or not reporting to the lenders might be an option for a borrower to ’buy’ a bit more time; generally, there cannot be a financial covenant breach if no Compliance Certificate or financial statements are supplied to the Agent, and a failure to supply such information typically does not become an Event of Default until 10 to 20 business days after the due date. A decision to knowingly breach contract, however, should not be taken lightly; see below under ‘A final word’ regarding directors’ fiduciary duties.
Planned utilisations and rollovers	Facilities are usually drawstopped if there is a Default or Event of Default, whereas rollovers of existing term loans under an RCF tend to be permitted until there is an Event of a Default or a Declared Default (acceleration). The parties will need to consider if the company’s cashflow forecast is premised on new utilisations and/or loan rollovers.
IAS 1 and year-end	Special care is needed when a company that reports under International Accounting Standards (‘IAS’) may be at risk of breaching a financial covenant at its financial year-end. This is because of the impact of IAS 1, which provides that if a loan is in breach at the reporting date and not waived on or before that date, any waiver obtained after that date is treated by the auditors as a non-adjusting post-balance sheet event. That means that the company’s audited accounts will show all debt under the relevant facilities agreement as current (i.e. due in 12 months), which can be disastrous for a lot of businesses. The usual solution to this is to extend the relevant test period so that it ends after the year-end date, say 30 days later.
Regulation	If the business operates in a regulated sector, it may have an obligation to notify its regulator of an Event of Default and perhaps of a forecast default. In some cases, this may have other implications, such as triggering an obligation to post additional collateral with the relevant regulator or other counterparties.
Key contracts	The business may have key contracts which terminate, or are terminable, if its debt facilities are in default (the definition of which will vary and may be critical). The company may also have reporting obligations to its key trading partners which are engaged by a default under its debt facilities.
Liquidity	The business may need additional working capital which no party (including the sponsor) is willing to provide without the forecast breach being waived or otherwise satisfactorily addressed.
Hedging	The business may have hedging contracts which are terminable if the debt facilities are in default. This may result in a requirement to make significant payments to the hedge counterparty (e.g. mark to market crystallisation).
Directors’ duties	A responsible board will want to know that its proposed approach (to a forecast breach) is consistent with the directors’ fiduciary duties. See below under ‘A final word’ for further information on this.

Section 3

Options

(A) Waiver
Lenders waive the test before the test date or reporting date.

(B) Amendment
Lenders agree to re-set the relevant covenants to levels that are expected to be passed.

Options (A) and **(B)** are two different ways of achieving the same thing.

Neither typically happens other than as part of a longer-term arrangement, unless: (i) it's a one-off and the lenders are satisfied that the business is sound; or (ii) it's done on the basis that the lenders know that it's a temporary fix because the company will have another request in the short term (e.g. because of new covenants set in return for the waiver/amendment, or because it's clear that the company will fail covenants when next tested, typically in 3 months' time).

(C) Equity cure
Sponsor exercises its contractual right to inject the requisite amount of cash to cure the default.

This **Option (C)** will happen only if the sponsor is motivated to protect its investment without needing any concessions from the lenders, the borrower or any other stakeholders in return.

(D) Temporary waiver
Lenders defer the reporting date (and the test date, if needed), to see if terms can be agreed for a longer-term arrangement.

Option (D) is the most common means of stabilising the business while discussions and work on any longer-term proposals continue.

The length of the waiver period will generally be set according to the time needed for the requisite work and any negotiations to be concluded, subject to there being an urgent new money need. Lenders tend to set conditions with two key objectives: (i) information gathering and insight (enhanced information covenants and appointment of own advisers); (ii) prevent or mitigate against the loss of value (cash management, no disposals, etc).

(E) Standstill
Default occurs and the finance parties formally suspend their enforcement rights, on terms.

Option (E) is similar to **Option (D)** above save that with **Option (E)** the Event of Default has occurred (and is continuing) and will generally 'spring' back into force and be actionable immediately at the end of the standstill period.

Lenders may, tactically and/or optically, prefer **Option (E)** over **(D)** if the lenders are comfortable with any third party and other commercial risks as a result of an Event of Default. Or, it may occur because the lenders are not aligned. See further section 5 below.

(F) Default Occurs
"No deal".

Not generally any party's choice but reasonably common in practice. This may happen for a short period while terms are agreed for a temporary waiver or standstill. For reasons explained above, the lenders would be advised to serve a reservation of rights letter as soon as practicable after the default has occurred. See 'learn more' box.

Learn More: reservation of rights

Facility agreements usually contain a 'no waiver' clause, under which the lenders' rights are expressly reserved if they fail to exercise, or there is a delay in exercising, any of their rights. But, a lender may nonetheless be taken to have waived its rights by its conduct.

A risk for lenders, for example, is that by reference to ongoing discussions and perhaps with the borrower continuing to service the loan, the borrower asserts an argument that the lenders have, by their conduct, affirmed the (lending) contract and thereby impliedly waived their rights in respect of a default. A borrower could also run an argument, based on the concept in equity of *estoppel*, that there has been a representation by the lenders on which the borrower has relied to its detriment.

For these reasons, lenders will want to take care with how they interact with a borrower and, as a general rule, issue a reservation of rights ("RoR") letter promptly after an Event of Default occurs.

Section 4

Perspectives

Borrower and sponsor

- To help with the sponsor’s aim of maintaining control, it will want the borrower to present a coherent proposal to the lenders as part of any ‘ask’ for a waiver and/or amendment. A good reference point is: what points will the lenders’ creditor committee want answered to agree to the ‘ask’?
- There may be merit in engaging specialist financial advisors to help generally in devising the company’s proposal, and specifically with managing the lender group. This may also help with deterring the lenders from engaging their own financial advisors (the success of which will depend on the degree of the distress and what’s at stake).
- The borrower’s own finance/treasury team may need additional resources to address the underlying causes of the business’s difficulties and/or to meet the lenders’ thirst for enhanced financial information.
- A key challenge is managing working capital appropriately (see below re. directors’ duties) to ensure the company has sufficient runway to agree terms with the lenders (and any other party).
- The sponsor will want to manage carefully the information flow to lenders and the level of professional costs.

Directors

- This can be a challenging time for the executives playing ‘piggie in the middle’ between the lenders and the sponsor: it may at times feel like having two masters with different demands.
- The board’s obligation to act in the best interests of the company continues, but the nature of this duty changes when a company is in the zone of insolvency. The board may need to seek advice on whether the so-called ‘creditor duty’ has arisen and, if so, what that means. See further below under ‘A final word’.
- Investor directors may need reminding that they owe the same fiduciary duties as the executive and any non-executive directors.
- Special measures may be needed to manage any conflicts of interest and the information flow as between the board and the sponsor.
- The company’s lawyers will typically advise the board, as a whole, on its fiduciary duties.
- There may come a point when it is no longer appropriate for the borrower and sponsor to have the same legal counsel.

Lenders

- Most lenders will want to concede as little as possible until they have had the information and time to assess the position.
- Lenders will generally defer covenant tests instead of waiving them (or, in some cases, if necessary, allow defaults to occur and issue a RoR letter or agree a standstill – see section 3 above) and will require enhanced information rights.
- They will generally be aligned with the borrower/sponsor in wanting to stabilise the business to preserve value (or at least not destroy value) while the potential options are identified.
- A priority will be to understand and probe the cashflow forecast and specifically the cash burn, which may hit the lenders £ for £ if the company fails.
- A loss sharing arrangement may need to be agreed if the lenders’ respective positions could change during a waiver or standstill period.
- The lenders will generally want their own financial advisers at the cost of the company. This is a common battleground: who, when, with what scope and at what cost.
- They will also require their own legal advice at the company’s expense (usually, this will be an existing contractual obligation of the company if it has requested an amendment or waiver).

Section 5

No meeting of minds?

Not all borrowers play nicely; neither do all lenders, who may not be aligned in their approach.

We set out below why this happens and consider the key legal risks that arise as a result.

Why this happens

- **Time:** time runs out before the lenders agree to a waiver or an amendment.
- **Disagreement on terms:** common points of disagreement include:
  - lenders' insistence on having their own financial advisers, which tends to be expensive when cash is already tight it, and which can consume valuable time of senior management and may destabilise key personnel/the business generally;
  - extent of enhanced reporting obligations; and
  - pricing: amendment/waiver fee and/or change to interest margin.
- **Tactical:** the borrower/sponsor may think it is in their interests to starve the lenders and their advisers of key operational and financial information:
  - it is generally challenging for lenders to devise a 'lender-led' plan without certain key information; and
  - see below regarding directors' fiduciary duties.
- **Distrust:** there may be distrust as to the use of the information: are the lenders genuinely interested in finding a way to support the business, or do they have another agenda (e.g. a 'loan to own' to strategy)?
- **Confidence:** the borrower/sponsor may be confident in the prospects of achieving their own solution without needing the lenders' support (e.g. a refinancing or sale may be imminent).

Know the risks and how to manage them

Veto on enforcement?

- The key risk for the borrower and sponsor is that, once there is a continuing Event of Default, the lenders could at any time accelerate the debt and enforce any security.
- To address this risk, for a borrower which does not have the support of the requisite majority of lenders to achieve a waiver, a short term "fix" may be to seek the support of enough lenders to constitute a veto:
  - Typically, acceleration needs **more than** $66^{2/3}$ per cent of lenders and so the support of lenders with $33^{1/3}$ per cent of the commitments may be enough to act as a veto.
  - Can the sponsor/borrower arrange for 'friendly lenders' to replace existing lenders? Do the transfer provisions permit this (voting rights via a participation, if assignment is prohibited)?

Utilisation conditions

- Another key risk or downside relates to liquidity: the facility may be drawstopped and query if revolving loans can be rolled-over.

Beware of unilateral rights

- The risk is greater if there is a payment default: most finance documents include a provision which prohibits lenders from taking unilateral action outside the framework of the finance documents. However, these provisions generally do not exclude a lender from exercising its own legal rights, outside the finance documents, as a creditor with due and payable debt.
- As such, a lender which has not been paid interest or principal (including on maturity of a revolving loan (see below)) can usually exercise the same rights as any unpaid creditor, including filing a winding-up petition.
- Ancillary lenders may be able to cancel key working capital facilities, including an overdraft facility or BACS facility.

Directors' duties

- See next page.

A final word: fiduciary duties

- The board of directors of a borrower forecasting a default will want to consider if the board should be seeking legal advice on the directors’ fiduciary duties.
- This is because a director’s fiduciary duties can change depending on how high the risk is that the company may fail (enter in insolvent administration or liquidation).
- Specifically, there can come a point at which the directors are obliged to have regard to the interests of the lenders (and other creditors) alongside the interests of the company’s shareholders, or possibly to the exclusion of the interests of the shareholders. This concept is referred to as the ‘creditor duty’.
- Lenders will sometimes see the need to press this point in discussions with borrowers and seek confirmation that the directors are taking advice on their fiduciary duties. This may include asking if the same law firm can and should be advising both the company and the sponsor (noting that it’s common for investor directors to be on the board).
- Directors should carefully consider if and when the interests of the company start to diverge from the interests of the sponsor. This may require certain actions, including the appointment of separate advisors.
- For more guidance on fiduciary duties when a company is in financial difficulties, see the following CMS briefing: **Companies in distress: directors' duties and helpful tools**

CMS Locations

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