# COVENANT-LITE LOANS
## TRAITS AND TRENDS

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Covenant-lite loans, which largely disappeared during the credit crunch, have reappeared in the syndicated loan market. This article examines the typical features of covenant-lite loans and the benefits and drawbacks for borrowers and lenders.

Covenant-lite (cov-lite) loans became widespread at the top of the last credit cycle before the 2007 credit crunch. During the credit crunch, however, new cov-lite loans largely disappeared from the market because lenders had greater market power to reject these types of borrower-friendly deals (see *Box, What is a Covenant-lite Loan?*). At that time, many market participants thought that it would be many years before new cov-lite loans returned. However, starting in 2010, cov-lite loans began reappearing in the syndicated loan market.

>> For a Practice Note on cov-lite loans and their reemergence after the financial crisis, including links to recent cov-lite loans, search What's Market: Covenant-lite Loans on our website.

Borrowers can obtain cov-lite loans because of market dynamics. At the top of the last credit cycle, there was an oversupply of capital, and lenders competed for deals from private equity sponsors and borrowers. Because there was a greater supply of capital than there was demand to borrow capital, borrowers had more leverage to negotiate looser and more favorable terms, including cov-lite structures.

Currently, two key factors are influencing market dynamics:

- Interest rates are low. As a result, more debt investors are now looking to the leveraged market for higher yields than those available in the investment grade market.
- Leveraged merger and acquisition activity has not increased enough to keep up with demand. Therefore, certain borrowers still have enough negotiating power to insist on more favorable terms. Sponsored borrowers and higher-rated leveraged borrowers are most likely to obtain cov-lite loans.

WHAT IS...?

### WHAT IS A COVENANT-LITE LOAN?

A covenant-lite (or cov-lite) loan is a borrower-friendly type of loan facility found in some, but by no means all, leveraged financings. Cov-lite loans are most likely to be found in syndicated loan transactions.

The core feature of any cov-lite loan is the absence of financial maintenance tests requiring the borrower to meet certain performance criteria monthly or quarterly (see *Box, Purpose of Financial Covenants*). A cov-lite loan also typically has a covenant package with features similar to high-yield bonds, including incurrence-style negative covenants. However, cov-lite loans can come in many different variations having some or all of the features discussed in this article (see *Cov-lite Loan Provisions*).

This article explains the:

- Typical provisions of cov-lite loans.
- Elements of post-credit crunch cov-lite loans.
- Pros and cons of cov-lite loans for borrowers and lenders.

## COV-LITE LOAN PROVISIONS

Although every cov-lite loan transaction is different, there are some common patterns and themes in the structures. In the period before the credit crunch, cov-lite features were most commonly found in cash flow financings. They also appeared in asset-based lending transactions.

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# Purpose of Financial Covenants

Financial covenants are one of the key protections for lenders in a leveraged loan transaction. Syndicated loan transactions generally are either investment grade or leveraged. Leveraged loans are perceived to have greater credit risk than investment grade loans.

Most often the distinction is determined by the rating on the loan from a rating agency. A loan with a rating in one of the four highest rating categories is typically an investment grade loan. A loan with a rating below the four highest categories is a leveraged loan. A loan without any rating can also be categorized as investment grade or leveraged based on how the borrower's credit profile, including its leverage ratio or interest or fixed charge coverage ratio, compares to rated loans for similar borrowers.

Because of their perceived greater credit risk, leveraged loans typically have greater protections for the lenders. These protections include, but are not limited to:

- Guaranties and security interests from the loan parties.
- Negative covenants limiting voluntary activities by the loan parties such as incurring indebtedness, selling assets, making investments or acquisitions, paying dividends or prepaying or repaying other indebtedness.
- Mandatory prepayments from the borrower from asset sales, excess cash flow and certain other events.
- Financial maintenance covenants to be satisfied by the borrower.

## COMMON FINANCIAL MAINTENANCE COVENANTS

Financial maintenance covenants require a borrower to meet certain financial performance criteria periodically, usually quarterly but sometimes monthly. Failure by the borrower to meet the financial performance criteria can result in a default under the loan documents which potentially can have several adverse consequences (see below *Consequences of Non-compliance*).

There are many types of financial maintenance covenants, but the most common are tied to an agreed definition of the borrower's cash flow available for debt service. Often this is defined as EBITDA (earnings before the deduction of interest, taxes, depreciation and amortization). Common financial maintenance covenants are:

- **Maximum leverage ratio.** The borrower must not exceed a specified ratio of debt to EBITDA (or some other cash flow measure). Depending on a borrower's capital structure and market conditions at the time of the loan, leverage tests can apply to total debt, secured debt, senior debt or first lien debt, and the loan agreement may include a combination of leverage tests.
- **Minimum interest coverage ratio.** The borrower must, at a minimum, meet a specified ratio of EBITDA (or some other cash flow measure) to interest expense. As with leverage tests, depending on a borrower's capital structure and market conditions at the time of the loan, interest coverage tests can apply to total interest or only cash interest that is payable on total debt, secured debt, senior debt or first lien debt, and the loan agreement may include a combination of interest coverage tests.
- **Minimum fixed charge coverage ratio.** The borrower must, at a minimum, meet a specified ratio of EBITDA (or some other cash flow measure) to an agreed definition of fixed charges. Some of the items that can be included in fixed charges are interest expense, capital expenditures, dividends and other distributions and scheduled payments of principal. In some deals, several of these items may be subtracted from EBITDA in the numerator of the ratio rather than included in the fixed charge denominator.

>> For a Practice Note providing more information on financial covenants, search Loan Agreement: Financial Covenants on our website.

A leveraged loan that has financial maintenance covenants may have one, some or all of the covenants described above. The definitions and required ratios are set when the loan is negotiated. Normally, the required ratios are based on financial projections prepared by the borrower for the lenders plus a cushion on top of the projected performance. The purpose of financial maintenance covenants is to provide the lenders with an early warning that the borrower is not performing as expected and that action to improve performance or adjust the loan terms may be needed.

Financial maintenance covenants apply any time they are required to be tested, usually at the end of a quarter or, sometimes, at the end of a month. The borrower is required to comply with the financial maintenance covenants regardless of whether it is looking to engage in a transaction restricted by its negative covenants or is currently able to pay its debt service and other obligations when due.

In contrast, an incurrence-based negative covenant only applies when a borrower wants to voluntarily engage in a transaction or activity restricted by that covenant. An incurrence-based negative covenant prohibits a borrower from those actions only if it does not comply with the specified covenant. Therefore, a borrower that is underperforming relative to its projections can avoid violating its incurrence-based negative covenants by not engaging in the activities restricted by those covenants.

>> For more information on negative covenants, search Loan Agreement: Negative Covenants on our website.


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## CONSEQUENCES OF NON-COMPLIANCE

Failure to comply with financial maintenance covenants can have serious and adverse consequences for a borrower. In almost all loan agreements with financial maintenance covenants, failure to comply with any one of them will result in an immediate event of default under the loan documents.

One exception to this rule is if the loan agreement has an equity cure right. This right gives the borrower's parent company a right to contribute equity to the borrower in an amount that, when added to EBITDA, would cause the borrower to be in compliance with the failed financial maintenance covenant.

Equity cure rights, while not uncommon, are not a panacea for a borrower that is failing a financial maintenance covenant. The equity owners might be unable or unwilling to use the right, especially if the amount needed to cure is large or the borrower is expected to fail the financial maintenance covenant again on future test dates. In addition, the use of equity cure rights may be limited by the terms of the loan agreement. Although these rights are highly negotiated and vary from deal to deal, there are often limits on the number of times and the number of consecutive times they can be used. There may also be limits on the size of the equity cure amount, either individually or in the aggregate.

Generally, loan agreements treat all events of default more or less equally. Upon an event of default, lenders have the right, among others, to demand immediate repayment by accelerating the debt and to exercise collateral remedies. In practice, however, market participants do not treat all defaults with the same level of gravity. The most serious are payment and bankruptcy defaults. The next most serious are financial maintenance covenant defaults because they are a warning that a payment default or bankruptcy might be pending for the borrower.

The consequences for a borrower of a financial maintenance covenant default are numerous and varied and will depend on several factors, including the specific terms of the borrower's loan agreement and the composition of the lender group. The consequences of a financial maintenance covenant default can include:

- **Loss of liquidity.** In a loan agreement with a revolving credit facility, it is usually a condition precedent that no default or event of default exists at the time a new loan is made. Even if the revolving credit is governed by a separate loan agreement that does not contain the failed financial maintenance covenant, the revolving credit agreement is likely to contain a cross-default provision to the loan agreement with the failed financial maintenance covenant, thereby preventing the borrower from satisfying the condition precedent.
- **Reputational damage.** If the borrower is a public company or has public debt outstanding, it may have an obligation to disclose any breach of a financial maintenance covenant. Depending on the nature of the borrower's business, this disclosure can cause customers to leave and go to competitors who are perceived to be more financially sound. It can also cause suppliers to tighten credit terms, potentially further straining the borrower's liquidity.
- **Increased interest costs.** Many leveraged loan agreements require (or may allow lenders to require) the borrower to pay a default interest rate on its loans. This rate is often a 2% per annum increase over the non-default rate. The borrower may also have to start using a higher index for determining its interest rate (such as base rate instead of LIBOR). Both of these consequences can potentially further strain the borrower's liquidity.
- **Cross default.** A financial maintenance covenant default in one loan agreement may result in a cross default in some or all of a borrower's other indebtedness. This can lead to greater pressure for protective bankruptcy filings to fend off aggressive creditors.
- **Distraction to management.** Management may need to spend significant time negotiating an amendment, restructuring or workout of the loan terms in order to waive a financial maintenance covenant default. This can distract management from running the business or fixing the problems responsible for the underperformance.
- **Acceleration.** The lenders may choose to accelerate their debt and demand repayment, which is very likely to lead to a bankruptcy filing.

In addition, if a borrower cannot meet its financial maintenance covenants or, possibly, if prior to a default a borrower cannot show its auditors projected compliance, the auditors may issue a "going concern" qualification in its annual audit because of all the consequences that can result from an event of default. In most leveraged loan agreements, this alone may cause an event of default because of a requirement for the borrower to deliver an unqualified audit. As a result, depending on the timing of when a borrower is no longer able to show projected compliance with its financial maintenance covenants, a borrower may have a default tied to its financial maintenance covenants long before it actually fails a test.

>> For a Practice Note explaining events of default in loan agreements, including the rights and remedies of lenders, search Loan Agreement: Events of Default on our website.

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## CASH FLOW DEALS

A typical cov-lite cash flow loan has the following structure:

- One loan agreement that includes both a funded term loan or series of term loans and a relatively smaller revolving credit facility. However, there is a trend towards lenders refusing to provide revolving credit facilities in cash flow financings (see below *Elements of Post-Credit Crunch Cov-lite Loans*).
- All of the credit facilities share the same covenants (other than financial maintenance covenants), mandatory prepayments and events of default.
- All of the credit facilities are secured by the same collateral, which the facilities share ratably.

Generally, these deals either have no financial maintenance covenants or financial maintenance covenants that only apply to the revolving credit facility (see *Box, Purpose of Financial Covenants*). In the latter case, remedies upon a breach of the financial maintenance covenants (usually a single covenant, such as a maximum leverage ratio) will be within the control of the revolving credit lenders only. The revolving credit lenders (usually by majority vote of the class), to the exclusion of the term loan lenders, will have the power to:

- Amend the terms of the financial covenants.
- Declare an event of default relating to a breach of the financial covenants.
- Direct the exercise of remedies (including termination of commitments to lend, acceleration of debt and foreclosure of collateral) resulting from an acceleration based on breach of the financial covenants.

Only if the revolving credit lenders do not agree to a waiver of the breach within a specified time period (usually between 45 and 90 days) can the term loan lenders declare a default and begin exercising their remedies for the breach of the financial maintenance covenant.

It is also typical in these cov-lite loan transactions for the financial maintenance covenants to be "springing" in nature. This means they will only apply to the revolving credit facility if certain thresholds are met. For example, the threshold can be that no revolving credit loans are outstanding or the revolving credit outstandings are below a certain dollar amount or percentage of the total revolving commitments. As a result, the borrower can avoid being required to meet any financial maintenance covenant if, at the time the covenant would otherwise be measured, it reduces its revolving credit usage below the threshold trigger.

In contrast, in deals with full financial maintenance covenants, breach of one of these covenants is normally an immediate event of default regardless of the amounts outstanding at the time. If an event of default occurs, all of the lenders (term and revolving lenders voting as a single class) by majority vote can exercise available rights and remedies.

## ASSET-BASED LENDING

Cov-lite loans can also be structured using an asset-based lending (ABL) component for the revolving credit portion. Typically, this involves an ABL revolving credit facility with a separate cash flow term loan (or multiple term loans).

In these transactions, the ABL revolving credit facility is documented separately from the term loan, and will have a different covenant package and prepayment events. The ability of the borrower to use the ABL facility is limited by a borrowing base formula often tied to a percentage of accounts receivable and a percentage of inventory meeting certain eligibility criteria in the ABL documents. The ABL documents generally have a springing financial maintenance covenant for minimum fixed charge coverage. Unlike a cash flow cov-lite loan transaction where springing covenants are tied to the usage of the revolving credit facility, the trigger in an ABL cov-lite transaction is tied to the amount of remaining availability under the borrowing base formula.

In an ABL cov-lite transaction, the term loan is documented in a separate agreement that would not have any financial maintenance covenants. To prevent the term loan lenders from getting the benefit of the ABL financial maintenance covenant, the term loan agreement usually has a cross acceleration to the ABL facility rather than a cross default. This means the term loan lenders only have an event of default in their transaction related to the ABL facility if the ABL facility has an event of default and the ABL lenders accelerate their debt as a result.

>> For more information on ABL transactions, search Asset-based Lending: Overview on our website.

## COMMON COV-LITE FEATURES

The absence of a financial maintenance covenant for the benefit of the term loan lenders is the core feature of a cov-lite loan. Cov-lite loans also often have other borrower-favorable terms that make them more like high-yield bonds than traditional loan transactions with full covenant packages. In particular, cov-lite loans have looser negative covenants. Many cov-lite loans allow the borrower to take one or more of the following actions, subject to certain restrictions:

- **Incur additional debt.** Rather than having a hard dollar cap on the amount of other debt a borrower can incur, many cov-lite loans allow an unlimited amount of debt if the borrower meets an incurrence test after giving effect to the incurrence of the new debt. Often the incurrence test is a maximum leverage ratio or a minimum interest coverage ratio.
- **Incur additional secured debt.** Even if a borrower can incur additional debt, additional liens on the collateral may not be permitted by the security arrangements entered into with the initial lenders. However, some cov-lite loans allow the borrower to grant additional


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Cov-lite loans often have other borrower-favorable terms that make them more like high-yield bonds than traditional loan transactions with full covenant packages.

liens to secure newly-incurred debt (thereby diluting the security of the initial lenders), if the borrower meets an incurrence test. Often this test is a maximum leverage ratio that applies to secured debt or first lien debt.

- **Pay dividends.** Rather than prohibit dividends or cap them at a fixed amount annually or over the life of the deal, or both, many cov-lite loans allow unlimited dividends (much like a typical high-yield bond deal), subject to a limit based on a percentage of net income or EBITDA at any given time.
- **Make acquisitions.** Rather than cap acquisitions at a fixed amount, per acquisition, annually or over the life of the deal (or some combination of caps), many pre-credit crunch cov-lite loans allow unlimited acquisitions, subject to the borrower showing pro forma compliance with an incurrence test. Often, in transactions with both a revolving credit facility and a cov-lite term loan governed by the same document, this incurrence test is pro forma compliance with the level set out in the financial maintenance covenant applicable to the revolving credit facility at that time, regardless of whether the covenant is required to be complied with at that time. Other tests may be a maximum leverage or senior leverage test at a level set out in the acquisition covenant.
- **Repay junior debt.** A common negative covenant in leveraged loans is limitations on repaying junior debt. Junior debt can be second lien, unsecured or subordinated debt. Likely, the junior debt is more expensive than the leveraged debt for the borrower so it is beneficial for the borrower to pay down the junior debt. Many cov-lite loans allow borrowers to repay junior debt subject to compliance with an incurrence test.

## ELEMENTS OF POST-CREDIT CRUNCH COV-LITE LOANS

Generally, post-credit crunch cov-lite loans have many of the common features and provisions described above. For example, recent cov-lite loans do not have any financial maintenance covenants for the benefit of the term loans and include looser incurrence-based negative covenants.

However, one trend that was emerging before the credit crunch and has continued since is the reluctance of lenders to provide revolving credit facilities in cash flow financings. This means that a leveraged borrower's debt structure will include an ABL facility for the revolving portion that funds ongoing liquidity needs. Therefore, the cov-lite cash flow term loan is documented in a separate loan agreement and does not benefit from any financial maintenance covenants in the revolving facility agreement, even after a standstill period.

## PROS AND CONS FOR BORROWERS

Cov-lite loans present the following benefits for borrowers:

- **Reduced risk of default.** Freedom from having to meet financial maintenance covenants allows a borrower to keep its credit facility in place even if the business underperforms relative to expectations as long as interest and other obligations are met. This removes the risks to a borrower of having extended and possibly costly workout negotiations with its lenders to waive or avoid a financial maintenance covenant default, which can result in higher interest rates, payment of fees and loss of negative covenant flexibility. It also lowers the risk of other negative consequences of breaching the financial maintenance covenants (see *Box, Purpose of Financial Covenants: Consequences of Non-compliance*).
- **Greater flexibility.** The looser incurrence style negative covenants that are often included in cov-lite loans enable the borrower to engage in other transactions (such as acquisitions) without having to worry about seeking lender consent, paying consent fees or being unable to obtain the necessary consent.
- **Reduced risk of losing ownership or control.** When a borrower defaults, or might default, it may find that there are divergent goals among its lenders. Traditional lenders such as banks, insurance companies and certain new categories of lenders, such as CLOs and prime rate funds, may have a goal of repayment in full or having a loan with market terms that will trade at par on the secondary loan market. Other lenders, such as hedge funds and distressed investor funds, may view the ownership of the troubled borrower's debt as a path to owning or taking control of the borrower. The more difficult it is for the borrower to default, the harder it is for the distressed investor to try and obtain control of the borrower.

For a borrower, there does not appear to be many disadvantages in having a cov-lite loan. A borrower may have to pay a slightly higher interest rate for a cov-lite loan, although this is not universally true. A borrower that pays more for a cov-lite loan may end up overpaying if it performs as expected or better and does not use the additional flexibility of the incurrence style covenants. However, the incremental cost, if there is one,

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is small and the benefits generally seem to greatly outweigh the costs.

Another risk, especially in a transaction with a combined revolving credit and term loan in one document, is that because only 50% of the much smaller revolving credit facility (rather than 50% of the entire debt amount (term loan plus revolving facility)) is needed to block an amendment or declare a default, an activist lender can potentially gain greater influence and control over the process with a smaller investment. A borrower may have consent rights over assignments to lenders, but it may be hard to keep out the activist lender because that right has to be exercised reasonably.

Other arguments against a cov-lite loan from the borrower's perspective are theoretical. Some have argued that a borrower and its management benefit from the focus and discipline of having to meet financial maintenance covenants quarterly, and as a result, they may do a better job of maximizing profit. Another argument is that incurrence style negative covenants can allow a borrower to engage in transactions that would otherwise be restricted by a fully-covenanted deal, which may involve taking on too much debt or overpaying for an acquisition.

## PROS AND CONS FOR LENDERS

From a lender's perspective, cov-lite loans may dilute many key lender protections, such as:

- **Early warning of payment default.** The early warning provided by the periodic financial maintenance covenant can alert lenders in advance of a possible payment default or bankruptcy.
- **Avoiding unfavorable transactions.** The lack of control otherwise provided by tighter negative covenants can allow the borrower to enter into transactions that are not beneficial to the lenders.
- **Security interest in collateral.** The ability of the borrower to incur additional secured debt may dilute the lenders' collateral coverage for their loans.
- **Priority over junior creditors.** If the borrower is permitted to repay higher-cost junior debt prior to a default on the lower-cost credit facilities, the senior lenders would then have to work out loans with an underperforming or over-leveraged borrower without the cushion of the junior debt (whose repayment depleted the borrower's available cash).

In a fully-covenanted transaction, if the borrower cannot meet its financial maintenance covenants or wishes to engage in a transaction that the negative covenants prohibit, the borrower and the lenders can negotiate a waiver or amendment. In these negotiations, the lenders, acting as a group, have the option to provide relief in return for concessions by the borrower that either compensate the lenders for increased risk (such as increased interest and fees) or further protect the lenders through tighter covenants or new events of default. The lenders also have the option to refuse to provide relief and try to exercise remedies or precipitate a bankruptcy. In a cov-lite deal, these options are significantly reduced.

>> For a Practice Note describing the process of amending a syndicated loan agreement, search Loan Agreement: Amendments on our website.

The benefits for lenders in a cov-lite loan are more limited. As discussed, the lenders may receive a higher yield than in a fully-covenanted loan. However, other benefits seem to be highly theoretical. One argument is that the lenders may ultimately recover more if an underperforming borrower is given time to improve its performance without the pressure of financial maintenance covenants and the costs and distractions of a workout.



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