Paul|Weiss

Private Equity Digest

September 2019, Issue 27

A Covenant-Lite Refresher

Covenant-lite loans have surged in the last couple of years. In 2018, cov-lite loan volume in the US reached $911 billion, an approximate 26% increase over 2017, and accounting for 85% of leveraged loans in the U.S., the highest percentage on record.

Through August 2019, cov-lite loan volume in the US soared to approximately $940 billion, about 3% more than the total for 2018. As of August 31, 2019, close to 80% of all outstanding par leveraged loans were covenant lite.

In terms of market provisions, certain borrower-friendly provisions became even more borrower-favorable in 2018. Despite some pull-back in the fourth quarter of last year, the prevalence of this borrower-friendly environment is continuing into 2019.

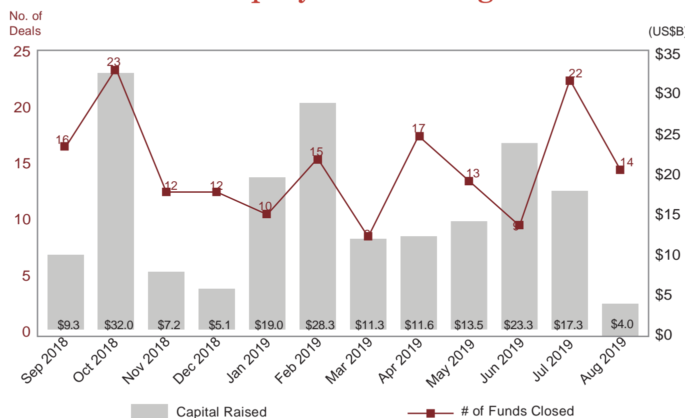
Our Finance partner, Eric Goodison, and practice management counsel, Margot Wagner, review below some of the most common cov-lite provisions and pros and cons for lenders and borrowers.[1] In our view, the current market remains favorable to PE sponsors borrowing under cov-lite terms.

Common Cov-Lite Features and Developments in 2018 - Early 2019

The absence of a financial maintenance covenant for the benefit of the lenders is the core feature of a cov-lite loan. Often there are other borrower-favorable terms that make the restrictions on the borrower 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:

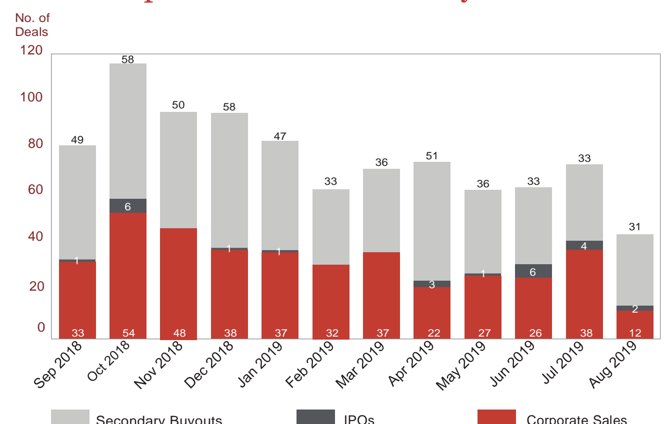
- ***Incur additional debt***. Rather than having a hard dollar cap on the amount of additional debt a borrower can incur, many cov-lite loans allow an unlimited amount of debt above an untested cap if the borrower meets an incurrence test after giving effect to the incurrence of the new debt. Often the incurrence test is a maximum leverage or net leverage ratio or a minimum interest coverage ratio. Additionally, in most cov-lite transactions, if a borrower incurs debt under its fixed incremental basket and its ratio basket at the same time, it can exclude the fixed amount from the ratio calculation.
- ***Incur additional secured debt***. Even if a borrower can incur additional debt, additional liens on the collateral may not be permitted by initial lenders. However, cov-lite loans typically allow the borrower to grant additional 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 or net leverage ratio that applies to secured debt or first lien debt.

U.S. Private Equity Fundraising



Source: Pitchbook

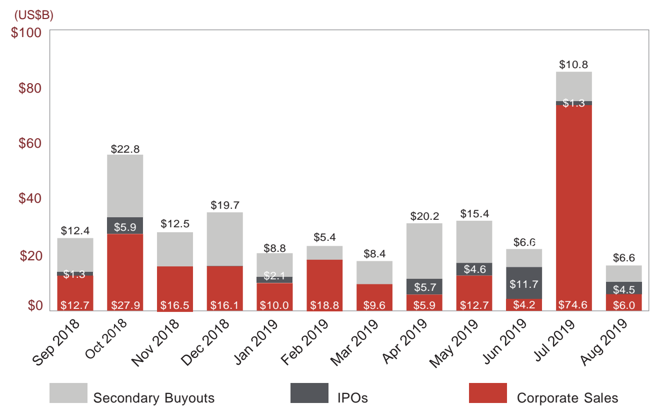
U.S. Sponsor-Backed Exits by Number



Source: Pitchbook

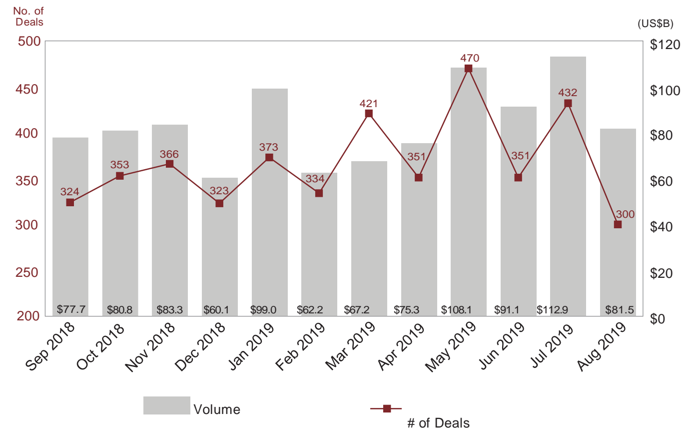
- ***Incremental debt***. Incremental debt provisions continue to be more borrower friendly in 2019.
  - ***Amount of debt***. The fixed amount of incremental debt permitted and not subject to any ratio incurrence test has increased. Often the fixed amount now includes a grower concept so that the fixed amount is the greater of a dollar amount and a percentage of EBITDA. This provides the borrower with greater flexibility to incur more debt without being in pro forma compliance with the incurrence ratio. The borrower often has the ability to reclassify the incremental debt that was incurred under the fixed amount basket as having been incurred under the ratio basket.
  - ***Most favored nation pricing protection***. Rather than maintaining strict protections for existing lenders under incremental debt provisions, many most favored nation provisions (MFN) became more borrower-favorable by (a) completely excluding from the MFN a fixed amount of incremental debt, (b) permitting a basket of incremental loans to mature sooner after the maturity (or have the same weighted average life to maturity) of the then existing term loans than previously allowed, (c) permitting a higher interest rate spread (75 basis points or more) between the incremental loans and the then-existing term loans, and (d) excluding from MFN protection the proceeds of incremental loans to be used to finance an acquisition. In some multicurrency facilities, the MFN may only apply to term loans made in the same currency as the new incremental loans.
- ***Basket reclassification***. Borrowers are frequently permitted to reclassify indebtedness originally incurred under the initial fixed dollar-based baskets as debt incurred under a ratio-based basket once their financial performance improves enough to satisfy the relevant ratio test. Reclassification permits borrowers that have fully used up their dollar-based baskets to re-load the baskets (*i.e.*, provide for additional capacity). Reclassification is often used in both the general indebtedness basket as well as the fixed dollar-based basket in the incremental facility provisions.
- ***Mandatory prepayments***. Some borrowers successfully negotiated leverage-based step-downs for the excess cash flow and asset sales subject to mandatory prepayment requirements with the ability to add the retained amounts to the available basket that can be utilized, among other purposes, to make restricted payments, investments and to prepay junior debt. Additionally, soft call repricing protections

U.S. Sponsor-Backed Exits by Dollar Volume



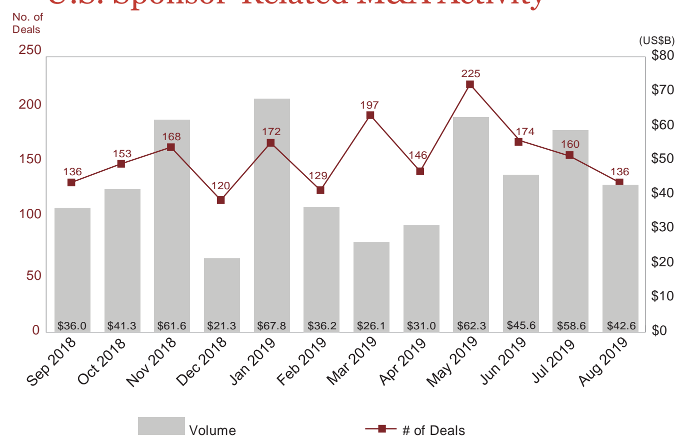
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Cortex

U.S. Sponsor-Related M&A Activity



Source: Cortex

Each metric in this publication that references deal volume by dollar value is calculated from the subset of the total number of deals that includes a disclosed deal value.

have weakened in some cases by reducing the fee the borrower must pay to lenders in connection with certain repricing transactions undertaken by the borrower or shortening the period of time the protections apply.

- ***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 dividends (much like a typical high-yield bond deal), subject to a limit based either on a percentage of net income or EBITDA at any given time and, in many transactions, on an unlimited basis, subject to satisfaction of a leverage or net leverage test.
- ***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), cov-lite loans typically allow unlimited acquisitions, subject, in some cases but not all, 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. The level may be based on the closing leverage or slightly above or below it.
- ***Repay junior debt***. A common negative covenant in leveraged loans is limitations on repaying a defined class of junior debt. Junior debt may include second lien, unsecured or subordinated debt. Likely, the junior debt is more expensive than the borrower's first lien debt 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.
- ***EBITDA addbacks***. Borrowers and sponsors continue to obtain friendly EBITDA adjustments. Since most covenant compliance, grower baskets, and potentially pricing are determined by reference to EBITDA, this issue has become heavily negotiated. Current borrower-friendly trends to EBITDA adjustments include: permitting projected cost-savings not connected to acquisitions or reorganizations, increase or removal of caps on pro forma cost savings synergies, longer look-forward periods, board expenses, severance and relocation costs, synergies of a type shown in a sponsor's QOE report, accrued dividends on preferred stock, expenses due to exercise of employee options, indemnification payments that are reimbursable by third parties, and others.
- ***Collateral leakage and designation of unrestricted subsidiaries***. As cov-lite agreements have become more borrower friendly, lenders have grown increasingly concerned about collateral leakage out of the restricted group from whom the lenders are primarily looking to be repaid. Several negative covenants, taken together, provide flexibility for loan parties to move assets to entities outside of the credit group. In this regard, the credit agreement covenants are moving to resemble high yield bond packages. However, some deals now limit the ability of a borrower to transfer key assets to an unrestricted subsidiary as a result of one high profile transaction where a borrower used this flexibility to move material IP to an unrestricted subsidiary.

In all of these covenants, the incurrence-based tests will often be additive to the fixed dollar baskets found in traditional credit facilities.

Types of Cov-Lite Deals

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, possibly, a relatively smaller revolving credit facility. If there is no revolving credit facility, a separate ABL may be used in cash flow financings.
- All of the credit facilities share the same covenants (other than, if there is an included revolving facility, financial maintenance covenants or springing financial maintenance covenants), mandatory prepayments and events of default.
- All of the credit facilities are secured by the same collateral, shared ratably.

Generally, these deals either have no financial maintenance covenants or financial maintenance covenants that apply only to any included revolving credit facility. 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 or waive 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 the revolving commitments to lend, acceleration of debt and foreclosure of collateral) resulting from an acceleration based on breach of the financial covenants.

In certain transactions, 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) the term loan lenders may 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 with included revolvers 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 any revolving credit loans are outstanding or the revolving credit outstandings are above a certain dollar amount or percentage of the total revolving commitments. A borrower may also be able to negotiate a basket for issuing a certain amount of letters of credit before the covenant applies. 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. For this reason, among others relating to credit risk, lenders may in some transactions require the financial covenant to be satisfied on a pro forma basis as a condition to making new revolving credit loans or issuing or extending letters of credit.

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, the agent or 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 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/or 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 typically 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 occurrence of an event of default in the ABL facility will not trigger an event of default under the term loan facility unless and until the ABL lenders have accelerated their debt.

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 including a potential cross-default to other agreements. Although the default rate for loans is below the historical average, the average recovery rate for cov-lite loans has fallen since the 2010 credit crisis. Over the last twelve months, among defaulted loans, over 70% were cov-lite loans.
- ***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 seek lender consent or pay consent fees.
- ***Reduced risk of losing ownership or control***. In the event of an actual or potential default, borrowers often find divergent goals among their lenders. Traditional lenders such as banks, insurance companies and certain institutional investor 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 in 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 do 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, 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 the potential for an activist lender to obtain voting power disproportionate to its share of the facility. 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 new lenders, but it may be hard to keep out the activist lender because that right has to be exercised reasonably. To help protect against this risk, many cov-lite loans require borrower consent (at least prior to an event of default or certain defaults such as payment or bankruptcy) for assignments of revolving credit commitments to lenders that only hold term loans. An activist lender is not likely to seek to own the revolving commitment prior to the borrower experiencing distress, so this feature may make it easier for the borrower to keep them out of the revolving credit facility.

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 limits 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.

The benefits for lenders in a cov-lite loan seem to be more limited. As discussed, the lenders may (but may not) 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 enjoy a greater recovery 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.

[1] The full version of this article was first published by Practical Law on its Practical Law Finance web service at https://us.practicallaw.thomsonreuters.com/4-507-4687

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Questions concerning issues addressed in this memorandum should be directed to:

Matthew W. Abbott
+1-212-373-3402
mabbott@paulweiss.com

Angelo Bonvino
+1-212-373-3570
abonvino@paulweiss.com

Eric Goodison
+1-212-373-3292
egoodison@paulweiss.com

Marco V. Masotti
+1-212-373-3034
mmasotti@paulweiss.com

Robert B. Schumer
+1-212-373-3097
rschumer@paulweiss.com

Taurie M. Zeitzer
+1-212-373-3353
tzeitzer@paulweiss.com

Counsel Frances F. Mi, practice management counsel Margot Wagner, associates Bilal Manji, David Styles and Diana Windrim and law clerks John Crain and Alexia Yang contributed to this publication.

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