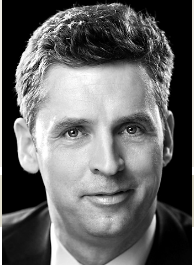

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Financial Covenants in the Triangle between Lenders, Equity Sponsor and Management

The financial market crisis has already reached the real economy. The earnings of businesses have been falling, sales figures have plummeted, the EBITDA is dwindling. The deteriorating financial situation of a business is, however, not only of great relevance for the management and the business owners but also for the creditors, especially for the lenders of capital, since they are strongly interested in the repayment of their capital.

Relevance of financial covenants

The law stipulates that there are statutory instruments alerting the shareholders of a GmbH (German limited liability company) and those of an AG (German stock corporation) to an upcoming crisis. In order to be able to react immediately to an emerging crisis, it is mandatory for the management of a GmbH or an AG to promptly call a shareholders' meeting as soon as one half of the registered share capital is lost. Shareholders should thus be given a chance to reorganize and restructure their business in due time. A similar "alert system" for business creditors is not specified by law. It is therefore quite difficult for them to recognize the signs of an impending crisis. As a result, they often discern the shadows of a critical financial situation in a certain business when its insolvency can merely be averted. This legal framework is barely acceptable from the point of view of lenders fearing for the loss of their granted loans. As a consequence, lenders demand so-called financial covenants individually from their borrowers in order to identify the indications of a business crisis as soon as possible.

Financial covenants refer to the financial situation of the borrower obliging him to comply with certain financial figures with regard to equity, debt, EBITDA and/or

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liquidity. Financial covenants may either be agreed upon as concrete values or as ratios. They are supposed to shed light on the ability of the borrower to repay his debt and to pay interest. If they are breached, the lender may recognize that the company's financial condition no longer meets the minimum requirements. The higher the risks taken by the lenders, the more important financial covenants become. Hence almost every facility agreement in the field of private equity contains financial covenants.

The determination of financial covenants in their function as creditor protection strongly depends on the given market circumstances. Lenders, for instance, made considerable concessions to borrowers in relation to financial covenants in 2006 and 2007 ("covenants-light"). Such decisions were caused by the high liquidity of the market, as well as intensified competition between lenders. In the recent past, however, financial covenants have been increasingly reinserted in facility agreements. As a result of the financial crisis, the risk awareness of banks has risen so that financial covenants are once more of essential importance.

Due to the present financial market crisis, financial covenants for newly granted facilities tend to be more rigorous. Also, businesses increasingly breach the financial covenants agreed upon in the past due to sluggish economic growth, as well as an initially too optimistic business plan. These two circumstances show the necessity to take a closer look at financial covenants in the context of a reasonably likely breach of the financial covenants on the one hand and in connection with the conclusion of facility agreements on the other hand. It is the intention of this article to deal with these issues: First we examine the question of whether a reasonably likely breach of the financial covenants may lead to (an event of) default. In this context, we also scrutinize the obligations of the management in case of a reasonably likely covenant breach. Subsequently, we describe typical contractual consequences as well as recent reactions of lenders to a covenant breach. Then, we illustrate some opportunities for businesses and their shareholders to avoid (at least temporarily) non-compliance with the determined financial covenants. Finally, we outline some recent developments we have experienced when negotiating financial covenants.

Reasonably likely covenant breaches

■ A reasonably likely covenant breach as (an event of) default

Compliance with financial covenants is usually tested quarterly. On a testing date, the management has to deliver a compliance certificate to the lenders proving that the financial figures for the past three months are in compliance with those determined in the facility agreement. Figures such as EBITDA are normally calculated at the end of a twelve-month period. The negative impact of declining order numbers due to the financial crisis is therefore only noticed with a delay, since originally "good" quarters of 2008 and the beginning of 2009 are still included in the calculation. In spite of this, it is often foreseeable whether a covenant breach is reasonably likely during the next or the next but one reporting period. The management and the equity sponsor are then confronted with the question of whether the bank should be informed of a reasonably likely covenant breach and whether the reasonably likely covenant breach instantaneously means (an event of) default.

A reasonably likely breach of financial covenants does not necessarily lead to (an event of) default and thus to considerable rights of the lenders such as raising interest rates, demanding additional securities or the free trade of the facilities on the one hand, as well as to additional obligations for the borrower, especially reporting obligations on the other hand.

If the financial condition of a business worsens to such a degree that a breach of the financial covenants seems reasonably likely in the upcoming reporting period, a violation of the so-called material adverse effect clause may be considered. According to this clause, (an event of) default can be presumed when such circumstances arise or are reasonably likely to arise which have a material adverse effect. Whether and when a material adverse effect on the basis of a reasonably likely breach of the financial covenants can be assumed, depends on the specific definition of "material adverse effect" in the facility agreement. If, according to the definition, the actual breach of financial covenants explicitly represents a material adverse effect, it can usually be concluded that a reasonably likely covenant breach also constitutes (an event of) default, because even the reasonably likely occurrence of an event (i.e. the actual covenant breach), which has a material adverse effect, causes (an event of) default according to most facility agreements.

However, a reasonably likely breach of covenants does not constitute (an event of) default as long as the facility agreement only defines such circumstances as a material adverse effect that have a material adverse effect on the ability of the borrower to perform its payment obligations under the finance documents. The sole fact of reasonably likely non-compliance with the determined financial ratios contains no statement about the borrower's liquidity. If, for instance, the equity of the borrower decreases to a level at which the net worth covenant is breached, this does not necessarily mean that the borrower may not be able to perform his payment obligations. In certain cases, a reasonably likely covenant breach may surely be the result of tight liquidity. Notwithstanding this fact, it shall be examined separately whether there is tight liquidity of the borrower together with the reasonable likely covenant breach which justifies a material adverse effect according to the respective definition.

The assessment of whether impending non-compliance with the financial figures is an (event of) default appears to be quite difficult when the material adverse effect is roughly defined as a deterioration of the financial condition of the borrower without any further detail. It is then of great importance to interpret the indeterminate legal term "material adverse effect" in every single case by means of the possible intent of the parties according to the facility agreement, the systematic of the facility agreement, as well as the specific wording of the material adverse effect definition. In these cases, a risk remains of interpreting the definition in such a way that a reasonably likely covenant breach always constitutes a material adverse effect and thus (an event of) default.

Duties of the management in case of a reasonably likely covenant breach

If a company is about to breach the financial covenants, the management shall prepare for its obligations. In the first place, the management shall be aware of the following reporting obligations:

- Upon becoming aware of the occurrence of (an event of) default, the borrower shall notify promptly the lenders thereof;

- An obligation of the management to inform the shareholders about a reasonably likely covenant breach may arise from the articles of association, from the rules of procedure of the executive board or from statutory law. Provided that the financial condition of the company worsens so significantly that the company loses one half of the registered share capital, the management should not only inform the shareholders but also promptly call a shareholders' meeting.

- Nota bene: Facility agreements often contain a clause obliging the management to also forward all documents it has submitted to the shareholders to the lenders!

From our point of view, it is recommended that the management inform the shareholders as well as lenders as soon as a covenant breach is reasonably likely, even if no obligations to report are explicitly stipulated. It is essential for the relationship with the lenders that the communication between the parties is always as detailed, prompt, open and well-coordinated as possible. Only in this way may the management maintain the trust of the lenders in the ability of the company to repay the granted facilities. For syndicated facilities this is even more important. A considerable and lasting covenant breach may trigger doubts in the syndicate about the correctness of the information memorandum provided by the borrower for the syndication of the facilities. The lender having arranged the syndicate might thereby be pressurized by the other lenders. The arranger then transfers the pressure to the borrower.

In order to rely on the goodwill of the lenders, the management ought therefore to prepare a presentation for the lenders and, if necessary, to engage external financial advisors. The Following issues should be included in the presentation:

- Reasons why the breach of covenants was not foreseeable;
- Reasons why the financial covenants were breached;

- Explanation of the actions to correct the current situation;
- Expectations of ability to once again comply with the financial covenants.

Such a presentation might be the basis of a draft waiver proposal prepared by the management. The waiver proposal could be combined with an offer of a margin increase or additional security. The optimal time to submit such proposal might be right before the testing date on which the covenants will be breached.

Legal consequences of a covenant breach

- **Consequences of a covenant breach according to the facility agreement**

Non-compliance with the financial covenants regularly constitutes an event of default under the facility agreement. The occurrence of an event of default normally gives the lender the right to (automatically) amend the facility conditions, e.g. to increase the interest rate, as well as the right to:

- Accelerate (parts of) the facilities;
- Demand additional securities from the borrower or his shareholders;
- Deny the raising of other facility lines;
- Require the securitization of pending guarantees in cash;
- Assign and transfer its rights and obligations under the facility agreement (also to non-bank institutions such as hedge funds) without the consent of the borrower.

- **Reaction of the lenders in case of a covenant breach**

Usually the lenders do not make use of all their rights in case of an event of default. Provided that it is a minor breach, the lenders might only force the borrower to amend some clauses of the facility agreement in the lenders' favor, as well as require some restructuring measures in order to enable the borrower to overcome the crisis, e.g. an increase of the share capital or the engagement of external financial advisors. Furthermore, a less dramatic breach of the financial covenants is often accompanied by an (automatic) adjustment of the borrower's obligations under the finance documents, e.g. an interest rate increase and/or further reporting obligations combined with a waiver fee.

In case of a deep and lasting covenant breach, there will usually be a renegotiation of the facility agreement. In the course of renegotiation, the following issues are usually discussed:

- Restriction of investment decisions of the borrower;
- Further tightening of the financial covenants after an interim period or recovery;
- Further increase of the interest rate;
- Granting of additional securities;
- Increase of equity and/or the borrowing of subordinated loans;
- In case of a lasting crisis, the borrower is often obliged to engage an external advisor who shall examine the investment and financial concepts and optimize them.

As soon as a settlement on further actions and the facility conditions is reached, the parties may agree upon a waiver of the covenant breach. The costs for the waiver and the renegotiation are borne in full by the borrower, together with a waiver fee. An alternative is the agreement of a standstill period (i.e. the occurrence of an event of default does not have any legal consequences for a certain period of time) so that the lender does not waive all his rights but reserves them.

In practice, the lenders only rarely make use of their right to accelerate the facilities. Acceleration usually results in a drastic deterioration of the company's financial condition so that its insolvency can no longer be avoided and further waiting could decrease the realizable assets. The reason for this approach is that the acceleration of the loans, especially in case of LBO financing, may lead to the insolvency of the borrower. The granted securities, however, often do not sufficiently cover the granted facilities.

- **Liability risks for the management and conflicts of interests in case of a covenant breach**

In case of a breach of the financial covenants, the company's management bears an increased liability risk. A serious violation of obligations by the management leading to personal liability may be caused by the following events/circumstances:

- Forbidden payments of (part of) the registered capital of the company to a shareholder;
- Payments to shareholders of a GmbH that are likely to cause the company's illiquidity;
- Violation of bookkeeping requirements, e.g. misleading bookkeeping;
- Insufficient risk control;
- Not calling a shareholders' meeting as soon as one half of the registered share capital of the company is lost;
- No or late filing of a petition for the institution of insolvency proceedings.

However, the management's liability under civil law does not apply vis-à-vis the company in the form of a GmbH, if management acts on the basis of binding shareholder instructions requiring, in general, an effective shareholders' resolution. A shareholders' resolution might be ineffective due to formal deficits of the shareholders' resolution (e.g. incorrect convening of the shareholders' meeting), the invalidity of the shareholders' resolution because of prejudicial treatment of creditors, and due to the invalidity of the shareholders' resolution by reason of acting against public policy, e.g. instructions to issue a false compliance certificate. However, the liability of the board of directors of a stock corporation may not be made inapplicable by way of binding shareholder instructions.

In the very challenging situation of the occurrence of an event of default under a facility agreement, the management shall also be – in order to avoid criminal liability – be especially aware of the elements of a crime as follows:

- Fraud, e.g. by confirming false financial covenants in a compliance certificate, in particular if the company has a revolving credit line;
- Violation of bookkeeping requirements or misleading financial statements;
- Delayed filings for the institution of insolvency proceedings;
- Failure to promptly inform the shareholders of the loss of one half of the share capital of the company.

Bearing in mind these extreme liability risks, the management of the borrower is naturally interested in fastidiously satisfying all its obligations towards its shareholders, the supervisory board and, in particular, the lenders.

On the other hand, from a shareholder's perspective it is essential not to concern the lenders by reporting too hastily, as the security position of the lenders worsens in the course of time and, correspondingly, the negotiating position of the shareholders in respect to a restructuring agreement with the lenders improves. Equity sponsors therefore often follow a strategy of retarding the process. Consequently, shareholders often pressure the management to broadly interpret any reporting obligations and to submit a compliance certificate to the lenders, even if compliance with the financial covenant is not clear.

Due to this conflict of interests between the shareholders and the management, it has become common practice for management teams to engage legal and financial advisors in case of a reasonably likely covenant breach.

Avoiding and curing covenant breaches

Taking into consideration the considerable legal consequences of a (reasonably likely) covenant breach and the liability risks for the managements, both the shareholders and the management teams are highly interested in avoiding a covenant breach or at least curing it ex post. Whether this is possible depends on the provisions in the facility agreement.

One way to avoid a reasonably likely covenant breach is by means of a so-called debt buy-back: A shareholder of the company – a direct debt buy-back by the borrower is not recommendable for tax reasons – acquires liabilities of the borrower (preferably below par) and thus reduces the company's obligations by contributing the acquired debt to the borrower. In case of a reasonably likely breach of a financial covenant that is calculated – inter alia – on the basis of the outstanding liabilities (e.g. debt/equity ratio, i.e. the relation of the net debt of a borrower to its equity), a debt buy-back may directly lead to compliance with the respective covenant.

A debt buy-back is often neither explicitly prohibited in a facility agreement nor – unlike an equity cure – explicitly permitted. However, in every single case, a debt buy-back raises a number of legal questions: Is the facility actually transferable to the shareholder? Does the shareholder as a transferee need a bank license according to the German Banking Act? Does the shareholder have a voting right although there might be a conflict of interests, i.e. being a shareholder as well as a member of the syndicate? Apart from this, there are numerous relevant tax issues at the level of the borrower. Hence a debt buy-back is an attractive instrument to avoid a covenant breach, but it always needs to be carefully examined as far as the legal permissibility and the possible tax consequences are concerned.

Much more distinct is the possibility in facility agreements to cure the covenant breach ex post. Some facility agreements from times of high competition contain a so-called Mulligan clause. According to this clause, a breach of the financial covenants does not automatically lead to an event of default; in fact, the breach is cured if the borrower complies with the financial covenants on the next testing date. This means: an event of default may only result from the breach of the financial covenants in two consecutive test periods.

More frequently than Mulligan clauses, facility agreements comprise an equity cure right for the shareholders of the borrower. Such rights stipulate that under certain circumstances additional capital from the shareholders may be contributed to the company – for instance, in the form of an equity increase, a payment into the capital reserve or a shareholder loan – and these contributions are considered in the calculation of the financial covenants. The appeal of an equity cure consists in the fact that a covenant breach may be cured ex post by a shareholder's payment without the lender obtaining any additional rights or charging any waiver fee.

However, the effectiveness of an equity cure depends on the concrete equity cure provision form in the facility agreement. Whether the cash contributed to the company influences only the cash flow or the EBITDA as well is, for instance, of substantial relevance. It is more favorable for the borrower if the payment is charged to the EBITDA since not only the cash flow cover (i.e. the ratio of the cash flow available for the debt service in a certain time period to the due debt service in that time period) might be cured, but also any EBITDA-related financial covenants, e.g. interest cover (i.e. ratio of the EBITDA of the borrower to the payable interest). A lender, on the other hand, prefers to charge the cash contributions only to the cash flow since an equity cure may only then influence the cash flow cover so that the equity cure is only attractive when the borrower has (short-term) liquidity problems.

(Re)Negotiating financial covenants

The current development in the credit markets appears to lead to a tightening of financial covenants in facility agreements. Lenders mercilessly refuse to agree to equity cure rights and Mulligan clauses in the facility agreements. In fact, lenders tend to demand security instruments for acquisition financing, heretofore used exclusively for project financing: For example, borrowers are asked to open a debt service reserve account and to pay any excess cash into this account. In the event the borrower does not comply with the cash flow cover, the cash in the debt service reserve account shall serve as a reserve.

Today it is therefore of great relevance for borrowers to define the figures in financial covenants in a dialogue with the lender in such a way that, even in case of operational fluctuations, compliance with the figures is reasonably likely. This requires a realistic business plan, the so-called "agreed base case model", as well as considering the specific sensitivity of revenue streams, cash flow and debt developments, as financial covenants refer to the financial condition of a borrower during the whole facility term and are determined on the basis of a borrower's business plan. If a borrower is unable to comply with the agreed covenants, it is a sign that the economic and financial condition of the borrower is not in accordance with the initial business plan. In the recent past, however, financial covenants were stipulated on the basis of overly optimistic business plans in order to ensure a maximum and low-priced facility. For instance, for some businesses undergoing broad sector-specific cyclical fluctuations, a continuous increase of the EBITDA was assumed.

Apart from a realistic business plan, from the point of view of a borrower adequate headroom belongs to the most important negotiating issues. The headroom describes the pre-defined free scope between the plan figures and the covenant ratios so that not every operational fluctuation leads to a covenant breach. In the past, however, headroom of 10 to 20% was insufficient, since an overly optimistic and unrealistic business plan was the starting point.

Conclusion

The financial crisis has once again renewed the importance of financial covenants. Today, financial covenants are often breached, since the prognoses were too optimistic at the time of the conclusion of the facility agreement during the years of a booming economy. The management therefore now faces the challenge of satisfying its obligations in case of a (reasonably likely) covenant breach. Extreme diligence is recommended for the management here because of the serious (personal) liability risks to which managers are subjected. In an already difficult situation, this implies an additional burden for the management, which shall not be underestimated, as well as a conflict of interests with the equity sponsor.

Moreover, in new facility agreements, the importance of financial covenants has recently increased. Financial covenants serve lenders for their risk management. As far as new facilities are granted during the economic crisis or old facilities are restructured, lenders use financial covenants as an instrument for creditor protection. In times of restricted lending, borrowers can hardly reject the offered conditions. In spite of this, it is highly recommendable for the borrower to prepare a realistic business plan in accordance with the lender and to ensure adequate headroom so that ordinary operational fluctuations in the future do not lead to a covenant breach.

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