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The impact of current market conditions on covenants under senior secured credit arrangements

Global Financial Crisis: Navigating and Understanding the Legal and Regulatory Aspects

This chapter addresses the impact on affirmative, negative and financial covenants in non-investment grade leveraged financings following the 2008-09 credit crisis.*

1. Introduction

Covenants in senior secured syndicated credit agreements contain an agreement by the borrower to limit how it conducts material portions of its business during the life of the financing. Once the basic economic terms of the financing are agreed upon, covenants are generally the most negotiated provisions of a credit agreement. This chapter addresses covenants in non-investment grade leveraged financings, investment grade and workout financings follow their own protocols. Readers should also note that credit agreements are negotiated documents by parties with different concerns and tolerances in respect of the commercial trade-offs in credit agreements, as well as of different levels of sophistication. Accordingly, the authors have no doubt there are credit agreements in the market that contain covenants with terms at variance with their experience.

Covenants are designed to control certain of the borrower's acts which the lenders believe are most important to ensure that the loan will be repaid as scheduled. This purpose is reflected in three types of covenant:

- affirmative covenants;
- negative covenants; and
- financial covenants.

Affirmative covenants require the borrower to take various actions, which range from actions that a responsible borrower would customarily take (eg, complying with laws, paying taxes and maintaining appropriate books and records) to actions designed for the particular credit transaction. These might include maintaining specified corporate debt ratings, granting additional collateral or obtaining a designated interest rate hedge agreement within a certain number of days of the loan closing.

Negative covenants are generally viewed as more important to the lenders in that they limit various commercial activities in which the borrower engages in the normal course. Without these limitations, borrowers might alter their business or consummate certain transactions in such a way as to compromise the credit and endanger the lender's investment. Negative covenants often include covenants with respect to:

- incurring additional debt;
- granting liens on a borrower's assets;
- making investments;
- entering into mergers or acquisitions and sales of assets;
- paying dividends;
- engaging in transactions with affiliates; and
- pre-payments of other obligations.

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As opposed to affirmative and negative covenants, which directly address actions the borrower must do or is prohibited from doing, financial covenants can be violated simply by an adverse change in the borrower's financial condition. Although financial covenants can take various forms depending on which aspects of the borrower's financial condition are of most concern to the lenders, the most common financial covenants measure the borrower's fixed charges for a period to its earnings before interest, taxes, depreciation and amortisation (EBITDA) for that period and the borrower's leverage as of the end of a period to its EBITDA for that period. Obviously, the components of EBITDA are critical to the effectiveness of these financial covenants. Financial covenants generally are established by lenders based on a percentage discount to the borrower's projections for the term of the loan facility. A violation of these covenants is in effect a yellow light – a quantitative signal that the borrower's financial performance has materially deteriorated to warrant a re-evaluation by the lenders.

The extent to which lenders have been able to impose covenants restricting borrowers' operations has been greatly influenced by the state of the credit markets. The effect of the 2007 and 2008 market disruption on specific covenants (and related definitions) is discussed below. Lenders are more inclined to grant less restrictive terms when the economy appears strong, at least in the short term, so that the loans would be expected to be repaid or refinanced and there is abundant liquidity for the originating bank to syndicate the loan. This liquidity also creates substantial competition among originating banks, which can result in them offering more attractive covenant terms in order to obtain the lead arranger role. This behaviour was observed in the mid-1980s prior to the crash of 1987 and most of the 1990s before the tech bubble collapsed. Conversely, when the economy sours, such as during those two downturns, lenders generally impose harsher covenant terms. The period from March 2005 to 2007 saw the most unprecedented evolution in the terms of bank agreement covenants.

When the material loosening of covenants became most extreme is a matter for debate, but the credit agreement

for the Sunguard buyout is as reasonable a transaction as any to look back to as establishing the template for borrower-friendly bank agreement covenants in leveraged financings. The covenant terms of that financing were promptly adopted by all top-tier (and near top-tier) private equity firms as the standard that they deserved (where they did not seek even more generous terms). The lending community, with minimal objection, capitulated to that standard. Given the liquidity in the credit market at that time and the ease with which lead arrangers could syndicate loans, the lack of resistance to the Sunguard standard is not surprising. This period of loose covenant terms (and easy credit) came to an abrupt halt in August 2007 when the sub-prime crisis paralysed the credit markets. Covenant terms became more restrictive in late 2007 and continued to tighten throughout 2008. As this chapter is being finalised, there is not yet any evidence that the pendulum is about to swing back.

2. Scope of covenants

One material change in covenants observable since the credit crisis began is their applicability to almost all of a borrower's subsidiaries. While this may not be intuitive, this change can be critical to the lenders' right to better control the entire range of the borrower's operations, as well as more completely measure the financial condition of its enterprise. During the mid-2000s financing boom it was common for covenants to be limited to the borrower and its 'restricted subsidiaries'. This term was not generally used in bank credit agreements although it is more common in public debt indentures. 'Restricted subsidiaries' are defined as all subsidiaries of the borrower except for 'unrestricted subsidiaries'. Various categories of subsidiary can be included within the definition of 'unrestricted subsidiaries', but usually it includes any subsidiary so designated by the borrower's board of directors (together with subsidiaries of such subsidiaries). However, there is a limit on the number of subsidiaries that can be classed as restricted, determined by a maximum percentage of the restricted subsidiaries' EBITDA compared to the EBITDA for the borrower and all its consolidated subsidiaries. When the concept of

'unrestricted subsidiaries' is included in credit agreements, specified procedures are set out as to how boards of directors should designate an unrestricted subsidiary as a restricted subsidiary and vice versa. These provisions are usually well negotiated but a board of directors is generally precluded from changing the designation of a subsidiary if a default exists or would result from this, or if the borrower is not complying with a leverage ratio on a *pro forma* basis. As mentioned, the benefit to the borrower of establishing the category of restricted /unrestricted subsidiary is that a sub-set of the borrower's subsidiaries is then outside the covenant's reach. However, the potential negative consequence to the borrower is that these subsidiaries are not included for EBITDA purposes in determining compliance with financial covenants. Credit agreements negotiated during the current financial crises have generally not included the concept of unrestricted subsidiaries.

In addition to creating a class of unrestricted subsidiary, credit agreements before the current market disruption sometimes contained categories of immaterial subsidiaries and excluded subsidiaries. In some agreements, these subsidiaries did not fall within the scope of the covenants, while in others they would be excluded only from the obligations to guarantee the obligations under the credit agreement and to grant security interest to secure that guarantee. These categories of subsidiary reflected a more rational balance between the needs of the borrower and the lenders, and have continued, when applicable, in many credit agreements during the current market disruption. 'Immaterial subsidiaries', as the name implies, are subsidiaries of a *de minimis* value (generally measured by assets and/or revenues of the proposed immaterial subsidiary as a percentage, when combined with all other immaterial subsidiaries, of the assets or revenues, respectively, of the borrower and all subsidiaries), such that it is not worth the additional transaction costs to include them as a guarantor or a grantor of collateral (and complete the related diligence). 'Excluded subsidiaries' include a broader range of subsidiaries from those listed on a schedule to the credit agreement to any foreign

subsidiary (which, as a result of tax considerations, generally do not provide guarantees of its US parent's obligations) to those prohibited by law or contract from guaranteeing the obligations under the credit agreement to special purpose subsidiaries. While the concept of excluded subsidiaries certainly survives, it is now a significantly more limited class of subsidiaries, which will be exempt from being subject to the covenants in a credit agreement.

3. Affirmative covenants

3.1 Financial statements and other reports

In addition to fiscal year-end audited financial statements and quarterly unaudited financial statements, lenders now require the delivery of unaudited monthly financial statements, including a consolidated balance sheet, as well as statements of income and of cash flows. Lenders are also requiring the delivery of:

- annual forecasts of balance sheets, income statements and cash flow statements prepared on a monthly basis for the first fiscal year in such forecast, as well as on an annual basis for each subsequent fiscal year;
- a budget, prepared on a quarterly and annual basis; and
- a copy of the management's discussion and analysis with respect to each quarterly and annual financial statements.

During the couple of years immediately preceding the current market disruption, the delivery of annual forecasts, quarterly budgets and management discussion and analysis was generally not necessary. The requirement for the delivery of the management's discussions and analysis is not significant for public reporting companies, since they would need to prepare them for their publicly filed documents. However, it is a significant requirement for non-public reporting companies, which would otherwise not need to prepare such a document. In certain transactions, borrowers are

also required to make their management available, through scheduled telephonic conferences, to discuss the contents of their discussion and analysis with the lenders.

Further, in connection with the delivery of the audited financial statements, lenders are being more insistent that the borrower's accountants certify that they have not obtained any knowledge of any default under the financial covenants in the course of their regular audit of the borrower's business, or, if they have obtained such knowledge, state the nature and status of such event. During the period of aggressive lending activity preceding the current market disruption, the borrower's accountants would resist providing such certification and lenders generally would not demand these certificates.

3.2 Environmental matters/compliance with terms of leaseholds

During the period immediately preceding the current market disruption, lenders did not always require affirmative covenants regarding environmental matters and compliance with terms of leaseholds. However, in the current market, few lenders are willing to proceed without such covenants.

Pursuant to the environmental matters covenant, the borrower and its subsidiaries must generally comply, in all material respects, with all applicable environmental laws and environmental permits, obtain and renew all environmental permits necessary for its business, and conduct investigation and undertake any clean-up of any hazardous materials, unless such an obligation is being contested in good faith and appropriate reserves are maintained. In addition, borrowers are typically required to notify the administrative agent with respect to certain environmental matters, including non-compliance with certain environmental laws or environmental permits and the release of any hazardous materials required to be reported to any governmental authority.

Pursuant to compliance with terms of leasehold covenants, the borrower and its subsidiaries must comply with all material obligations in respect of leases of real property, including lease payment obligations. While

covenants made before the current market disruption almost always contained a material adverse effect qualification, now any qualification is likely to be more specifically limited.

3.3 Ratings/interest rate hedging

During the couple of years immediately preceding the current market disruption, lenders did not always require borrowers to maintain ratings or to enter into and maintain interest rate hedge agreements. However, in the current market, it is difficult for borrowers to avoid the obligation to maintain corporate and senior credit facilities ratings from Moody's Investors Service, Inc and from Standard & Poor's Ratings Services, with an obligation to notify the administrative agent in the event of a downgrade in any of the ratings. In addition, to minimise interest rate risk to the borrower, lenders now include a covenant in which the borrower agrees to enter into, and to maintain, interest rate hedge agreements with persons acceptable to the administrative agent, covering a notional amount that is typically not less than 50% of the loans and commitments under the relevant credit facilities and providing for the counterparties thereto to make payments thereunder for at least two or three years.

3.4 Additional guarantors and security/further assurances

The additional guarantors and security covenant requires that subsidiaries or assets formed or acquired after the credit facility closed become guarantors or be subject to the collateral security arrangement. In the current market, the number of days given to the borrower to deliver applicable documentation and instruments to the administrative agent, including any supplemental guarantee and supplemental security agreement, in connection with the formation or acquisition of a subsidiary or assets has been shortened. Generally, the borrower has 30 days or less to comply with such delivery requirement, whereas before the current market disruption, borrowers had up to 45 days, sometimes

more, to comply. In addition, lenders require the delivery of a favourable opinion from the borrower's counsel as to the enforceability of such supplemental guarantee and supplemental security agreement and other relevant agreements, the sufficiency of certain actions as to the perfection of liens on relevant assets, matters of corporate formalities and other relevant matters as the administrative agent may request. Before the current market disruption, such opinion was not always required.

Lenders now generally require that all assets of the borrower and its subsidiaries, with limited exceptions, be part of the collateral package. For example, lenders are not automatically excluding deposit and security accounts and other assets specifically requiring perfection through control agreements, motor vehicles and other assets subject to certificates of title, letters of credit rights and commercial tort claims from the collateral package.

3.5 Maintenance of existence/maintenance of property/compliance with laws/payment of taxes

During the period of aggressive lending activity immediately preceding the current market disruption, lenders often allowed an exception to compliance with certain affirmative covenants, including the maintenance of existence, maintenance of property, compliance with laws and payment of taxes covenants, where failure to comply would not reasonably be expected to have a 'material adverse effect'. The definition of this term that was used before the current market disruption was substantially limited; for example, it was rare to include prospects in the definition. However, in the current market, the meaning has become considerably broader. 'Material adverse effect' is now often defined as:

- a material adverse effect on the business, operations, condition (financial or otherwise), performance, properties or prospects of the borrower and its subsidiaries, taken as a whole;
- a material adverse effect on the ability of the loan parties to perform their payment obligations under the loan documents; or

- a material adverse effect on the rights and remedies of the lenders or the administrative agent under any loan documents.

In addition, lenders are not allowing the same exceptions that were frequently available before the current market disruption.

4. Negative covenants

4.1 Liens

Senior secured syndicated credit agreements impose restrictions on the ability of the borrower and its subsidiaries to grant liens or encumbrances on their assets. As secured creditors, lenders want to limit any dilution or reduction in the assets, which would occur if they allowed other creditors to take equal ranking or senior liens. In addition, lenders generally want to avoid competing claims to collateral, even if such claims rank junior to their own. Customary exceptions are made for statutory and other ordinary course liens, and encumbrances that are generally expected to arise in the conduct of the borrower's business. In addition, exceptions are made for capital lease obligations and purchase money security interests (securing specific equipment or other assets), in each case subject to agreed maximum amounts. A general lien basket is also included in an agreed amount for miscellaneous secured obligations that may arise. Other exceptions may include baskets to allow certain subsidiaries that are not part of the credit group to grant liens to secure debt (eg, to allow a foreign subsidiary to access the local bank market on a secured basis), and baskets to allow the borrower and its subsidiaries to enter into factoring arrangements and securitisations subject to agreed limitations. Historically, there were few other exceptions that would allow for any substantial portion of the assets of the borrower and its subsidiaries to secure any of their obligations other than those arising under the credit agreement.

During the couple of years immediately preceding the current market disruption, borrowers pushed for increased flexibility to incur additional secured debt. One

of the arguments used to support this was that lenders had agreed to a certain leverage and security profile at the credit agreement's inception and therefore should not be entitled to greater coverage and protection than that which they initially bargained for. With a willingness in the market to accept such flexibility, new carve-outs and exceptions arose. However, lenders are resisting most of these new carve-outs and exceptions in more recent transactions.

Some of the key changes in the liens covenant during the period immediately preceding the current market disruption included larger baskets for capital lease and purchase money liens, and for general baskets. Restrictions on liens securing debt of subsidiaries that did not form part of the credit group were loosened and, in some cases, lifted altogether. Instead of simple dollar caps on the obligations secured by permitted liens, baskets were often tied to the greater of the permitted dollar amount and a percentage of consolidated tangible or tangible net assets, allowing for greater flexibility as the credit group grew. Traditional baskets for liens securing additional debt, including debt assumed as part of an acquisition, began to be supplemented by an incurrence test, permitting unlimited liens securing debt subject to a ratio test (usually senior secured debt to EBITDA) determined on a *pro forma* basis. Similar baskets and ratio tests were often found in respect of permitted junior financing. As noted above, recent transactions have seen a return to fixed dollar baskets and less flexibility in diluting the security package available to the lenders.

4.2 Debt

Senior secured syndicated credit agreements include restrictions on the ability of the borrower and its subsidiaries to incur, assume, create or otherwise become or remain directly or indirectly liable for any additional debt, other than expressly permitted types of debt that are typically subject to caps and refinancing limitations. As with many definitions in the negative covenants, 'debt' or 'indebtedness' is defined broadly. The covenant is designed to ensure that the credit group does not incur

more debt than it can reasonably service, given the cash flow being generated by its business, and to limit competing debt claims, similar to the lien covenant described above.

In establishing the debt covenant, lenders will seek to regulate the amounts and kinds of debt that the borrower and its subsidiaries can incur, subject to customary exceptions which should be forecasted in the budget delivered to the lenders. Customary exceptions include, among others, and subject to aggregate limitations:

- loans and letters of credit under the credit documentation;
- purchase money debt;
- capital lease obligations;
- acquisition debt; and
- debt in existence on the closing of the credit facility (which is usually listed in a disclosure schedule if it exceeds a certain dollar threshold).

Extensions, renewals and refinancings are often permitted subject to limitations on the principal amount, maturity, terms and obligors under such debt. Debt between and among the borrower and its subsidiaries is another common exception, with limitations in respect of loans entered into with subsidiaries that are not part of the credit group. It is common to require that any intercompany debt owed by an obligor under the senior credit facility be subordinated to such obligor's obligations under the senior loan documentation. The incurrence of additional debt, such as senior or subordinated high-yield bonds, will ordinarily be subject to constraints as to aggregate amount, tenor, weighted average life to maturity, redemption requirements and covenants. As with the lien basket, the credit agreement will contain a basket for miscellaneous debt that does not fit into any of the other exceptions.

Notable changes during the couple of years immediately preceding the current market disruption included greater flexibility for borrowers to assume debt through uncapped or larger debt baskets. The rationale advanced

was similar to arguments made for greater liens capacity, namely that the lenders had agreed to a capital structure and leverage profile that the borrower should be permitted to maintain. Increased baskets permitting subsidiaries outside of the credit group to incur debt became commonplace (eg, allowing foreign subsidiaries to access their local bank markets). These larger baskets were also common for purchase money debt and capital leases, acquisition debt and the general debt basket. Rather than a fixed dollar amount, basket sizes were often contingent on compliance with a *pro forma* incurrence test, permitting unlimited debt subject to a ratio test (commonly senior debt to EBITDA) determined on a *pro forma* basis. A number of deals permitted the incurrence of new debt based on a senior secured debt ratio which, in essence, permitted unlimited unsecured debt. If the collateral securing the senior debt were insufficient to cover the full amount of senior debt, this type of covenant could permit an unlimited amount of debt to be *pari passu* with the undersecured portion of the senior debt. Debt covenants and incurrence ratios, if permitted at all, in recent transactions are reverting to more conservative precedent, with a view to limiting potential dilution in the lenders' debt claims against the credit group, with most of these baskets being narrowed and, in certain instances, some exceptions being resisted altogether.

4.3 Investments

Senior secured syndicated credit agreements impose restrictions on the ability of the borrower and its subsidiaries to make investments, typically defined to include the making of equity investments in, acquisitions of and loans or advances to other persons. The investments covenant is designed to regulate the degree to which assets can be invested or advanced to persons outside of the credit group, with a view to preventing any material erosion in the asset base available to the lenders as secured creditors.

Customary exceptions include:

- investments in existence on the closing of the credit facility (which are often listed on a disclosure schedule if they exceed a dollar threshold);
- investments in other members of the credit group and, subject to a dollar basket amount, other subsidiaries of the borrower;
- permitted investments (typically encompassing a variety of high-quality investments such as government-issued or backed securities, highly rated commercial paper, short-term certificates of deposit and money market funds that primarily invest in highly rated securities);
- investments constituting acquisitions up to a negotiated aggregate dollar basket amount and other requirements (including restrictions on the type of business of the acquired entity, surviving debt and *pro forma* financial covenant compliance, and a requirement that the acquired entity form part of the credit group), and a capped general basket for investments not permitted under any other exception; and
- certain ordinary course items.

During the couple of years immediately preceding the current market disruption, investment covenants began to include larger basket amounts and greater flexibility in terms of the quantum and types of investment that the borrower and its subsidiaries could make. Permitted acquisitions baskets were modified to replace aggregate dollar caps with a *pro forma* financial covenant test, often tied to senior secured leverage, and to provide greater flexibility for the acquisition of entities that would not become members of the credit group. A growth basket was often included, calculated as a percentage of excess cash flow or consolidated net income (on a sliding scale from 0% to 50%, depending on leverage), and increased by equity proceeds not otherwise applied and, in some cases, proceeds of dispositions offered to pre-pay, and declined by, lenders, which could be used for general investments (often subject to a 'same line of business'

requirement) and permitted acquisitions. In recent transactions, there has been a return to smaller fixed dollar baskets and limitations on the types of entity into which investments are made, with a focus on ensuring that growth occurs primarily within the credit group.

4.4 Dispositions

As noted previously, the dilution of the borrower's assets and other collateral is of concern to senior secured lenders under senior secured credit facilities. A dispositions covenant helps to ensure that the actions of the borrower and its subsidiaries remain aligned with the interests of its lenders in terms of collateral protection, by limiting the amount of assets that can leave the credit group during the term thereof. The definition of 'dispositions' includes any sale, transfer, licence, lease or other disposition (including sale leasebacks and the sale of equity interests) of any property by any person. Sales, assignments, transfers or other disposals of any notes or accounts receivable, and any rights and claims associated therewith, will also be subsumed under the definition of 'dispositions'.

Common exceptions in senior secured syndicated credit agreements permit certain ordinary course dispositions (eg, sales of inventory in the ordinary course of business, ordinary course licences of intellectual property). In addition, dispositions intended for after the credit facility's closure may be scheduled as permitted dispositions. Transfers of assets among the credit group and, subject to basket amounts, among the credit group and other subsidiaries were commonly permitted. In addition, there is often a general dispositions basket that permits free dispositions of assets subject to an aggregate dollar cap, or both an annual cap and overall cap. In addition to a dollar cap, general baskets typically mandated that a fixed percentage (commonly 75%) of the consideration for a disposition be in the form of cash, and that it be consummated for fair market value. A small additional basket may also be included for miscellaneous dispositions to permit dispositions for other than cash consideration and without a fair market value requirement.

As aggressive lending activity increased before the current market disruption, consistent with a general push for greater flexibility on the part of the borrower and its subsidiaries, there was significant loosening of these limitations on dispositions. The size of basket amounts for permitted dispositions increased relative to the size of the credit group, often including a construct that dispositions were permitted up to the greater of a dollar amount and a percentage of consolidated tangible or tangible net assets to allow for growth. In some cases, dispositions for fair market value were permitted without restriction, subject solely to compliance with mandatory prepayment requirements (which typically included reinvestment rights, which effectively obviated the need to actually make the pre-payment), and, in some cases, a *pro forma* financial ratio test. In addition, controls on the types of consideration that the credit group could receive for disposed assets were also loosened to allow for certain kinds of non-cash consideration, which could consist of equity or debt instruments, cash equivalents or other assets.

Since the market disruption, there has been a return to more traditional restrictions on dispositions. In recent financings, the baskets and exceptions mentioned above have reverted to more conservative terms, with fewer carve-outs and aggregate limitations. In addition, mandatory pre-payment requirements are tighter in terms of the quantum of proceeds and the time period within which reinvestments can be made before disposition proceeds must be applied to prepay loans under the credit agreement.

4.5 Restricted payments

In senior secured syndicated credit agreements, a restricted payments negative covenant generally restricts dividends and other distributions of cash, property, rights, obligations or securities to the borrower's equity holders, as well as redemptions, purchases or other acquisitions of the borrower's equity by the borrower or any its subsidiaries or other returns of capital to the holders of the borrower's equity. This covenant typically covers payments and purchases by the subsidiaries of the

borrower, as well as the borrower itself, in order to avoid the covenant being circumvented through acts by the borrower's subsidiaries. A restricted payments covenant is intended to limit the outflow of funds from the creditor group (which has no direct benefit on creditors of the borrower).

During the years immediately preceding the current market disruption, the exceptions to this covenant had been loosened considerably to permit the same or similar increasing basket as for investments. This basket was calculated as a percentage of excess cash flow or consolidated net income, and determined on a sliding scale from 0% to 50% depending on a leverage ratio (either secured or total). In addition, proceeds of certain permitted equity issuances that were not otherwise applied to other permitted transactions were also allowed to be used for restricted payments. Interestingly, these baskets had no maximum limit and continued to grow over time. As the credit markets have tightened, exceptions to the restricted payments covenant have also been tightened to delete the concept of the increasing dividend/purchase basket and, instead, have included an annual limitation on amounts that may be applied to restricted payments as well as a maximum limitation during the term of the deal. As a condition to any such restricted payment, there can be no default that is continuing and the borrower must comply with a leverage ratio that is generally much tighter than the leverage ratios used in the sliding scales on which the prior increasing baskets were based.

Further, market convention previously permitted restricted payments to be made in order to pay the equity holders' operating costs and expenses without limitation. This flexibility has been eliminated in the current climate and there is now a small annual amount which may be used for these purposes. Also, the restricted payment covenant previously permitted restricted payments to be made by any subsidiary to the borrower or any other subsidiary. The market has retreated and now permits subsidiaries to make restricted payments only to the borrower or a guarantor (thereby requiring funds to flow to entities against which the lenders have a debt claim).

4.6 Fundamental changes

The restrictions on fundamental changes generally encompass mergers, consolidations, liquidations or any disposition of all or substantially all of the assets (in each case, relating to the borrower and any of its subsidiaries). Lenders require such restrictions on mergers and consolidations in order to prevent the assets of their obligor group from becoming subject to the debt and other liabilities of the entity with whom the merger or consolidation occurs. Restrictions on sales of all or substantially all of the assets of the obligor group protect the lenders from the business being fundamentally changed. Depending on which assets remain in the obligor group, there may not be enough cash flow generated to service the debt and the market value of the remaining assets may not be sufficient to cover the principal amount of the debt remaining.

Before the current disruption, borrowers or guarantors were often permitted to merge or consolidate even if the other entity party to such transaction was the surviving entity, so long as there was no default and the surviving entity expressly assumed the obligations of the borrower or guarantor, as the case may be. Recent tightening of bank covenants has also removed any flexibility which allowed obligors to reorganise under new states or change their legal form.

4.7 Transactions with affiliates

The transactions with affiliates covenant seeks to protect the lenders against diminution of the assets or value that supports their loans as a result of transactions that might be on unfavourable terms to the borrower and its subsidiaries solely because such transactions are with affiliates. Lenders worry that a controlling shareholder may want to prefer such affiliates over the borrower and its subsidiaries. As a practical matter, complex corporate groups often grow as a result of the benefits that their entities can provide to one another and, therefore, controlling shareholders frequently do not seek to ensure that the terms of all intragroup transactions are at arm's length.

Before the current market disruption, transactions with affiliates covenants often permitted:

- the payment of management and monitoring fees to the equity sponsors up to an amount permitted under a management agreement entered into on the closing of the credit facility; and
- customary payments to equity sponsors for financial advisory, financing, underwriting or placement services, or in respect of other invest banking activities (up to a certain percentage of the transaction value of the underlying transaction).

Recent changes in the credit markets have meant that such exceptions (which creditors may view as alternate forms of restricted payments to the equity sponsors) are no longer available.

In addition, many pre-market disruption transactions permitted tax-sharing arrangements without specifying the exact terms of the tax-sharing agreement. If a controlling shareholder has two separate chains of companies, a tax-sharing arrangement could require the borrower to pay all the taxes (even though the other chain has income), and not just the taxes attributable to its income. In the alternative, a tax-sharing arrangement could require the borrower to use its net operating losses to offset taxes attributable to the income of the other chain. More recent transactions either do not have an exception for tax-sharing arrangements or require the terms of any tax-sharing agreement to be satisfactory to the lenders or be on pre-approved terms.

4.8 Pre-payments of debt

Lenders typically want to restrict the ability of the borrower and its subsidiaries to pre-pay, redeem, purchase, defease or otherwise satisfy before the scheduled maturity any of their other debt. Scheduled amortisation payments, mandatory prepayments and regular payments of interest are permitted. Since the senior secured debt is at the top of the capital structures, lenders generally want to restrict free cash from flowing out to other creditors. Lenders often protect against the

downside; to the extent that the value of the collateral for the senior secured debt is not sufficient to cover the full amount of such debt, the remainder of such debt would, in a bankruptcy proceeding, be *pari passu* with the other unsecured debt. Therefore, from a senior secured lender's perspective, any free cash should be applied to pre-pay the senior secured debt rather than any other debt.

In many transactions completed before the current disruption, this covenant was limited to payments made on, or with respect to, subordinated debt (thus allowing unsecured senior debt to be pre-paid or redeemed in full). An exception to this trend was in first lien/second lien transactions where the first lien credit documents would often restrict payments made on the second lien.

As with the investments and restricted payments covenants, pre-market disruption transactions permitted pre-payments of subordinated debt and/or second lien debt with the same increasing basket based on a sliding percentage of excess cash flow augmented by proceeds of certain permitted equity issuances. From a senior secured lender's perspective, using cash to pre-pay debt benefits the borrower more than paying out a dividend and, therefore, there was no rationale for not being at least as permissive on pre-payments of debt as the restrictions on dividends.

Recent transactions restrict the pre-payment of all debt (not just subordinated debt) and have removed the increasing basket exceptions. Some recent transactions do not permit any pre-payment of debt other than with the proceeds of a permitted refinancing, while other transactions permit a small basket to be used for pre-payments of debt subject to there being no default and *pro forma* compliance with a leverage ratio.

5. Financial covenants

The recent disruption in the credit markets has also resulted in a tightening of financial covenants under new credit documents or existing credit documents that have been subject to amendments. Financial covenants have historically been an important component of the covenant

package in leveraged credits, as they test the borrower's financial position and/or performance over particular periods or at particular points in time. Financial covenants serve as a valuable tool to lenders, as they give lenders an early signal to a decline in the borrower's financial position and future ability to service its outstanding indebtedness. Financial covenants often consist of a maximum leverage ratio and a minimum debt service ratio (eg, an interest coverage ratio or a fixed charge coverage ratio).

As aggressive lending activity increased before the current market disruption, it was not unusual for top-tier sponsors to negotiate the removal of financial covenants from a covenant package altogether. This became known as a 'covenant lite' agreement. Such a package would include incurrence-based covenants similar to those found in bond indentures. Although borrowers were unable to remove financial covenants altogether in mid to lower-tier financings, they could negotiate much looser financial covenants. As a result of such absence or loosening of financial covenants, lenders in the current market can only watch the decline in the borrower's financial position without being able to take steps to restructure or otherwise protect their credit position until much later than would be the case if the credit documents contained tighter financial covenants (sometimes, not until a borrower actually defaults on its loan payments).

The two primary aspects of financial covenants that have been tightened in the current credit markets are the cushions and the adjustments applicable to such covenants.

In financings made during the years immediately preceding the current disruption that did include financial covenants, it was not unusual to see cushions of between 30% and 35% to the borrower's financial model, which reflected the factor that the lenders and the borrower would use in setting financial covenant levels. A higher cushion would give the borrower more margin before breaching its financial covenants in the event that its financial performance were to be less favourable than as forecasted in its financial model. In the current

market, as many borrowers are revising their financial performance projections downward, new or amended financings are setting cushions at much lower levels (eg, in the range of between 15% and 25%).

Financings during the couple of years immediately preceding the current market disruption saw an expansion in the scope of add-backs and other adjustments made to the financial definitions forming the basis of financial covenant calculations. For example, EBITDA determinations (which are most often used in leverage ratio calculations) were subject to a broad array of adjustments, including the exclusion of both cash and non-cash charges resulting from acquisitions, financings and restructurings, and the addition of *pro forma* EBITDA increases (including *pro forma* adjustments resulting from projected cost savings and other synergies) to give effect to acquisitions by the borrower. In addition, consolidated net income determinations (which are often used as the basis for EBITDA calculations) were subject to numerous exclusions and other adjustments, primarily to exclude the effects of non-recurring income statement items. Further, leverage determinations were often subject to a deduction for a borrower's cash on the balance sheet (referred to as net debt). As a result, financial covenant calculations were made on the basis of figures that bore little resemblance to the borrower's reported generally accepted accounting principles financial results and lenders were exposed to the risk of borrowers being in compliance with their financial covenants, even though their generally accepted accounting principles financial position was in steady decline. Therefore, in the current market, adjustments to financial covenant definitions are being scaled back so that the calculations are made on a basis that is much closer to the borrower's generally accepted accounting principles financial position. Particularly, consolidated net income is returning to the reported generally accepted accounting principles income statement figure and *pro forma* EBITDA adjustments are being subjected to increased lender oversight (eg, agent approval over and/or a cap on any adjustments). Lenders are seeking to obtain a fairer representation of the borrower's financial

position, thereby better aligning financial covenant calculations with their ultimate purpose: analysing the borrower's ability to service its outstanding indebtedness.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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