Proskauer

Private Credit Deep Dives – Covenant Cures (Europe)

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Notwithstanding at least some deterioration in documentation standards towards the top-end of the private credit market in recent years, maintenance leverage covenants have remained a pervasive feature of unitranche as an asset class and a clear point of distinction from high-yield bonds and syndicated TLBs. In the previous instalment of this deep dive series, we took a look at the factors affecting how such covenants are typically formulated, noting that lenders will, at least in theory, seek to ensure that in the event of future underperformance, the leverage covenant will breach before the business simply runs out of cash. Of equal importance to sponsors is the question of how, once a covenant is indeed breached, they can ensure with certainty that the lenders will not step in and enforce their security, likely by either appropriating the sponsor's equity or selling it to a third party. This is typically addressed via the "equity cure" provisions, which at their most basic will state that, provided the sponsor contributes a specified amount of cash equity into the restricted group, the covenant breach will be considered "cured" and the lenders will no longer have an actionable default. With current macroeconomic trends meaning it is likely that even defensive portfolios will see some uptick in default rates this year, such terms will continue to be at the forefront of the minds of sponsors and lenders alike.

This deep dive with Daniel Hendon (Partner) and Phil Anscombe (Associate), lawyers in Proskauer's Private Credit Group in London, will explain how equity cures typically function in practice and how the ability to "cure" a covenant default has in certain cases extended beyond the making of an equity injection. This piece will also describe how lenders try to limit the application of cures, how sponsors will often try to build in additional flexibility and the ways in which, absent careful drafting, their usage can sometimes be manipulated.

Traditional Construct

In its most traditional form, the equity cure gave the sponsor the opportunity to remedy a covenant default by delevering the group on a permanent basis using the proceeds of an equity injection. It should be noted that when we speak of “equity injections”, we are referring to either a true equity investment or, alternatively, a subordinated downstream loan from the holding company immediately above the banking group in the SPV stack. While the equity cure regime can apply to a number of different financial covenants, for simplicity and given it is by far the most common financial covenant, we have focused here on equity cures of leverage covenants. These provisions operate such that, upon delivery of the compliance certificate which showed that a covenant breach had indeed occurred on the most recent test date, the sponsor would have a certain period to make a new equity investment into the group (essentially a grace period during which the lenders would not be able to accelerate on the basis of that breach, often set at 20 business days in Europe, but more commonly 10 to 15 business days in the US). The proceeds of that equity investment would then, upon receipt, be required to be applied in prepayment of the term facilities. The equity cure provisions would then state that if covenant compliance for that period were to be recalculated using the lower debt figures to give effect to that prepayment, and the group would then be below the applicable covenant level, the breach would be considered “cured” and there would be no continuing default. For sponsors and equity co-investors, particularly if they are also lenders, it is important to consider up front how this will be achieved under the shareholder arrangements if there are minority equity investors in the structure. The equity cure regime has evolved in a number of different ways over the years in tandem with the shifting balance in negotiating power between lenders and sponsors. The key points that are currently subject to negotiation, and factors that affect how these might be formulated, are as follows:

Negotiation Points

- **Prepayment Requirement:** The requirement to make a prepayment of the term facilities with the proceeds of an equity cure has almost entirely fallen away in the private credit market. Instead, lenders are comfortable to trust that management will be best placed to determine the best usage of that cash, whether it be to retain it for liquidity or working capital purposes, making accretive investments or prepaying debt. This is consistent with the decline in other classes of mandatory prepayment in recent years, with private credit lenders generally preferring to stay invested rather than withdrawing capital early from the businesses they support. In

the scenario in which there is some kind of liquidity-focused covenant (e.g., interest cover or cashflow cover), it would be a little counterintuitive to immediately suck the cure amount back out of the business rather than allow it to boost cashflow.

- **Deemed Effect:** As a consequence of prepayments generally no longer being required, it became the case in Europe that when retesting covenant compliance after an equity cure had been made, the cure amount would instead be deemed to reduce indebtedness, given that there would be no actual reduction in indebtedness. While this deemed effect is required where the covenant calculates leverage on a gross basis, it is not strictly required when the covenant calculates leverage on a net basis, since the cash received will actually reduce total net debt. Sponsors also sometimes propose that the deemed effect apply not only for the current covenant test but also for the three subsequent covenant tests (i.e., until the quarter of the "cure" is no longer within the previous 12 months that is being tested via the covenant). Some lenders are sensitive to this, on the basis that they have no control over how the proceeds of the cure are actually spent and therefore find it difficulty to justify a continuing deemed debt reduction in subsequent periods if the cash has actually dissipated within the business. They may, therefore, either push back on this concept altogether or say that it only applies to the extent the cash actually remains on the balance sheet and, for the reasons set out above, if leverage is being calculated on a net basis, then to the extent the group still has the cash, net debt will accordingly be reduced anyway, without any need for "deeming". However, sponsors will argue that they should not be incentivised to hold the cash on the balance sheet rather than investing in EBITDA growth, which may take some time to feed into profitability following such an investment and that it is this that warrants the deemed debt reduction in subsequent periods. On larger deals, sponsors have frequently won this debate.
- **EBITDA Cures:** One of the most infamous innovations within the equity cure regime in recent years has been the advent of the EBITDA cure. An EBITDA cure means that instead of deeming a debt reduction, the sponsor may instead elect to deem the equity cure amount to increase EBITDA when recalculating covenant compliance. Given the debt quantum is generally a significant multiple of the group's EBITDA, this inflates the resulting impact of the equity cure by an equivalent proportion. European private credit funds were for a long time resolute in pushing back on this concept, but in the past two or three years it has become increasingly common to see the mechanism included, particularly on larger transactions. However, even where included it is still most common to see some sort of sub-cap included on its usage in Europe. For example, requiring that an EBITDA cure may not be used more than once or twice over the life of the facilities. This is in contrast to the US, where equity cure proceeds are universally applied to increase EBITDA.

- **Total Number:** Almost all deals contain a cap on the total number of equity cures that can be made over the life of the facilities. The reason for this is that, although lenders are generally willing to give sponsors the time and space to remedy growth and profitability issues, if the business is persistently underperforming then the lenders will want to retain the right to step in and protect their value recovery irrespective of how much new equity is put in. Typically, the cap is set at either four or five times over the life of the facilities, with the former being most common and the latter generally limited to large/top-tier transactions. Care should be taken when reviewing grids and term sheets to ensure that the cap is expressed to be a cap on all equity cures and not just EBITDA cures.
- **Frequency:** It is also almost universally the case that credit agreements will contain some kind of limitation on the frequency with which equity cures may be made. This limitation generally ranges from a requirement that there be no cures allowed in consecutive quarters (this is the most common position in the European mid-market), to no more than two cures being permitted in any 12 month period (seen on slightly more aggressive deals but substantively similar to the first formulation, other than that it permits consecutive cures; this formulation is the most common in the US), to no more than two consecutive cures being permitted (generally large/top-tier transactions only, as it could in theory permit three cures in four quarters). In each case, the concern on the part of the lenders is to ensure that the cure is a mechanism to be used in a scenario of temporary underperformance rather than where there are serious and sustained issues with the underlying business.
- **Overcures:** The ability to make an “overcure” is the ability to inject an equity cure amount in excess of the amount actually required to bring the group back into covenant compliance. It is important to think about this concept alongside the “deemed effect” section above. Although to some extent the lender will not care about an overcure in the context of the testing period in which the breach occurred, since a cure is a cure, it becomes a more material point if the cure amount will have deemed effect in subsequent quarters. In that scenario an overcure can effectively build in some additional underperformance headroom for the sponsor in advance of subsequent tests. This is particularly the case where the relevant overcure is an EBITDA cure, given the greatly enhanced effect of an EBITDA cure in reducing covenant calculation leverage. For this reason, where the “deemed effect” concept is included for subsequent quarters, it is common to see a prohibition on overcures that are EBITDA cures. So as not to prohibit the sponsor putting in more equity than is needed, as both in Europe and the US it is rare to “hard cap” a cure amount, it is common to state this so that an overcure is still permitted but any excess amount injected above the minimum amount required to cure the covenant breach by way of an increase in EBITDA will be treated as an additional debt cure

amount.

- **Pre-Cures:** The ability to make a “pre-cure” is the ability to apply an amount of equity that was injected prior to the date of breach for the purposes of making an equity cure. The first of these is generally noncontroversial, which is the ability to inject equity between the covenant test date and the date on which the compliance certificate is delivered showing that a breach has occurred, which may be several weeks later. This equity investment would technically have occurred before the default event. What is generally more contentious is the ability to designate equity injected before the test date even occurred. This, in turn, can present itself in two guises. The first is where sponsors argue that equity invested prior to the test date but in anticipation of the breach should still count as an equity cure. Given that leverage is almost always calculated on a net basis these days for covenant purposes, this argument is nonsensical in the context of a debt cure, as the equity put in would already have reduced net debt prior to the calculation on the test date. However, there is some rationale to the request if they wish to apply such an amount as an EBITDA cure. Accordingly, you sometimes see this position accepted but with the caveat that the relevant equity investment must have been notified to the lenders and designated as an equity cure amount for the next test date at the time it was invested and that it must not have been applied for any other purpose as at the test date. This is to ensure there is at least some clear connection between the equity investment and the impending default. The second and more aggressive formulation, seen only on large deals, is where the sponsor seeks the ability to designate any prior equity investment made by the sponsor since the closing date (sometimes also including any closing overfunding) as being a cure amount to the extent a breach later occurs, potentially years later. For the same reasons set out above, this is difficult to argue in the context of a debt cure, as the cash will already be accounted for if not spent. Even for an EBITDA cure there are clear concerns with this formulation for lenders, given that the fungibility of cash makes it incredibly difficult to determine if and how any such investment has already been applied for other purposes, and if there are liquidity issues the cash will likely no longer exist. This concept is often resisted by private credit institutions for those reasons but it is seen on some top-tier deals.
- **Application of Adjustment:** While not generally a contentious point, it is important for the documents to clarify that the adjustments to leverage that result from an equity cure only apply for the purposes of re-testing financial covenant compliance. The same adjustments do not apply for any other purpose under the documents where leverage is also required to be determined (e.g., calculating the applicable level of margin under a margin ratchet or the monetary size of grower baskets).

- **Round-Tripping:**Lenders on all transactions irrespective of deal size will be particularly keen to ensure that equity cure proceeds must be used for business purposes by the group, and not taken back out by the sponsor once the breach has been cured. It is, therefore, important to ensure that any builder baskets available for dividends/distributions or even investments in unrestricted subsidiaries, if the concept is included, should not “build” with new equity to the extent that new equity was provided as an equity cure. This is particularly the case where any of these builder baskets may be used without a leverage condition tested at the point of incurrence, which will typically only ever be a discussion point on the most aggressive deals. Lenders may also look to state that any other baskets (e.g., general baskets) that are available for such purposes may not be used to the extent funded with equity cure amounts. In instances that private credit documents include an “excluded contributions” concept, whereby certain equity investments may be designated as “excluded” and be freely taken back out by the sponsor at any time, the same exclusions should apply, though this is rare in Europe.
- **Double Counting:** Generally more of a drafting point than a contentious point of negotiation, care should be taken to ensure no “double counting” is permitted as a result of the equity cure mechanics. For example: (i) no EBITDA cure amount should both increase EBITDA and, as a result of remaining on balance sheet, also reduce net debt; (ii) no “deemed” debt reduction should reduce debt to the extent the cash remains on balance sheet and already reduces net debt and (iii) no deemed effect, whether to EBITDA or net debt, should apply where the proceeds have actually been applied to effect a debt reduction by prepaying the facilities. In the US, in relation to an EBITDA care, no deemed effect is given to any debt reduction even if the proceeds are actually used to prepay any debt at least for the relevant test period and potentially the next three test periods in lower middle market deals. However, one aspect that might be considered by some to be “double counting” but which is, in fact, generally permitted, is the ability of the group to generate pro forma EBITDA growth using the relevant cure amount and while it is continuing to have effect as a cure. What we mean by this is that once an equity cure amount is injected, that cash could in theory be used to underwrite a commitment for an acquisition/investment. The EBITDA of the acquired business or asset would then often be given pro forma effect in EBITDA calculations even if the same cure amount that funded the acquisition is still being given deemed effect as a cure.

Deemed Cures

While not technically “equity cures”, there are certain methods of curing covenant breaches that do not entail a new investment of new cash equity. These are typically described as follows:

- **Mulligan:**Included for completeness, as it is almost never seen in today's market but is a term that is occasionally misused by market participants. This was the principle that an actionable default would not exist for the lenders until the covenant had breached on two separate occasions.
- **Deemed Cure** – In contrast, this remains a prevalent feature of the European market. The way this works is that if a financial covenant breach occurs but, as at the following test date for the next quarter, the group is compliant with that subsequent test and the lenders have not taken any acceleration/enforcement action in the interim, the prior default will be considered cured for all purposes. Certain lenders do not like this provision as it effectively sets a clock ticking for them to negotiate, formulate an enforcement plan and strategy and then actually pull the trigger to accelerate prior to the next test date three months later, following which they may lose their right to enforce and recover value. However, sponsors would argue that if the group is back in compliance the following quarter then lenders should view that as a positive development in any case. Some lenders also look to either sub-cap deemed cures (maximum usage of once or twice over the life of the facilities) or state that it counts as an equity cure for the purposes of the cap on equity cures. Both limitations are typically only seen in the mid-market and deemed cures are often uncapped on large deals.
- **Early Deemed Cure** – This is a more recent, aggressive innovation towards the top end of the European market. It operates so that if the company recalculates covenant compliance for the breach period or any subsequent LTM period, even if that subsequent LTM period is not a quarterly test period and is in compliance with the last covenant test, the breach is considered cured. The only requirement is that the company must have sufficient available information to make such revised or updated calculation and must submit an updated compliance certificate. There are a number of potential issues with this for lenders. Firstly, it is unclear what form such "sufficient available information" should take and whether it would need to meet the same standards as are ordinarily required for quarterly financial statements, which usually accompany compliance certificates. Secondly, it is by no means clear that it is reasonable to report for a subsequent LTM period and suggest that the data should apply to the last covenant test level. In particular, it opens the door to the group implementing new transactions or initiatives in the interim and citing that extensive pro forma adjustments result from those initiatives that muddy the waters for lenders in terms of saying with a certainty that there is an actionable covenant breach. Thirdly, the mere presence of this provision in a document creates an unsteady platform for lenders. It is very difficult to negotiate with sponsors and plan a potential enforcement strategy if there is a constant threat of having the rug pulled from under your feet by updated numbers being presented that make it less clear whether or not you can still enforce. For these reasons this

concept is still strongly resisted by private credit institutions.

- **Sector-Specific** – On a very small minority of European deals we have seen specific rights included to cure a financial covenant breach where the sector in question has been subject to a temporary and unexpected shock. For example, a company exposed to the tourism sector may, if there is a natural disaster or terrorist attack in the geography in which they operate, elect to substitute their actual EBITDA for the relevant period with their corresponding EBITDA the prior year for the purposes of recalculating/curing the breach. Clearly this only provides some temporary respite.

One of the key attractions to sponsors of private credit financing solutions is that it is highly relationship-based lending. This stands in stark contrast to the syndicated loan market where borrowers generally have a very large and diverse pool of debt investors, the majority of which may never have any direct contact with the group's management. For this reason, amongst others, it remains significantly more common to see private credit managers reach negotiated solutions with sponsors and management in an underperformance scenario rather than looking to exit the transaction. On many occasions some kind of equity support from the sponsor will form a key part of that negotiated solution. Whether this is effected by way of an equity cure in a covenant breach scenario or as part of a wider package of amendments and waivers will be situation-specific. It is, of course, possible that in the event of a covenant breach the sponsor will flatly ignore the equity cure provisions and look to negotiate a different deal as a condition for their additional equity investment. On balance, any equity injection should be viewed as a positive by lenders, as it demonstrates both that the sponsor still perceives there to be equity value in the group and that they are ready to stand behind their commitment and support the business. Going forward, in any case, equity cures will continue to be seen by sponsors as a key component of their tool kit to keep control of their assets. With market conditions continuing to cause stresses within certain sectors, that does not seem likely to change in the near future. For any related questions on this topic, please reach out to your contact within Proskauer's Private Credit Group.

Related Professionals

- **Daniel Hendon**
  Partner
- **Bharat K. Moudgil**

Partner