Private Credit Deep Dives – Dodgy accounting or financial covenant breach (Europe)?

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Over the past year, we have observed a marked increase in Events of Default ("**EoDs**") arising from financial underperformance in the European mid-market. This trend is largely attributable to the prevailing high interest rate and inflationary environment, with borrowers facing escalating debt service costs and compressed revenue margins. For further information on EoDs and the remedies available to lenders, please see Private Credit Deep Dives – What to do following an Event of Default in a consensual setting (Europe) - Insights - Proskauer Rose LLP.

Against this backdrop, we have also seen borrowers and sponsors seeking to maximise the use of add-backs in loan agreements to inflate EBITDA figures and thereby maintain covenant compliance. There has been a notable rise in instances where private credit funds question or dispute the quarterly and monthly financials provided by borrowers. Such disputes occur less frequently with annual financial statements, as these are audited and therefore less susceptible to manipulation. The disagreements typically centre on whether the borrower has in fact satisfied its quarterly financial covenant maintenance test(s).

While it is understandable that borrowers and sponsors seek to maximise add-backs and adjustments to ensure compliance, financial reporting should nonetheless remain consistent with the accounting principles and practices agreed at the time of underwriting (the "**Agreed Accounting Rules**"). Preserving this consistency is essential to maintain the commercial intent of the transaction.

Where suspicions or disputes arise as to whether borrower-prepared financials deviate from the Agreed Accounting Rules - potentially inflating reported results - lenders have a range of options available to investigate. In such circumstances, financial reporting issues go beyond technical discrepancies and may point to a broader strategy of presenting a more favourable financial position than is in fact the case.

In this Deep Dive, Daniel Hendon (Partner) and Andrew Surgey (Associate) from Proskauer's Private Credit Group in London will: (i) outline how Agreed Accounting Rules are typically documented; and (ii) explore the options available to lenders where there is suspicion or dispute as to whether reported figures are accurate and comply with the Agreed Accounting Rules.

1. Typical Agreed Accounting Rules – Having Agreed Accounting Rules is designed to ensure that financial reporting remains consistent, transparent, and fair throughout the term of the loan, thereby protecting the interests of both lenders and borrowers. Put simply, it ensures "apples are compared with apples" when testing financial covenants against reported financials, and guards against "opportunistic" accounting methods that artificially inflate figures. The Agreed Accounting Rules are typically documented as follows:

> **(a) Consistency with base case model and original financial statements -** The parent is required to prepare its financial statements using the same accounting principles, practices, and financial periods as those used in the base case model (i.e., the financial model agreed at the outset of the deal and used to set covenant levels) and the original financial statements. On rare occasions, the accounting reference base may include buy-side financial due diligence reports. Minor differences due to customary year-end adjustments are permitted. The requirement to maintain consistency in reporting is standard across nearly all mid-market deals, although we are seeing some pushback in the upper mid-market.
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> **(b) Notification of changes** –
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> > (i) If the parent changes its accounting principles or practices, it must notify the agent (the lenders' representative) and provide:
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> > > (A) a description of the adjustments required for the financial statements to reflect the accounting basis of the original base case model or the original financial statements (as applicable); and

(B) sufficient information to enable the agent and lenders to assess compliance with financial covenants, determine the applicable margin, calculate prepayments from excess cash flow (where relevant), and compare the new financial position to the base case model or original financial statements.

(ii) As with the consistency requirement, this notification obligation is standard across nearly all mid-market deals, though we are increasingly seeing pushback in the upper mid-market.

(c) Negotiation - If there is a change in accounting principles or practices, the parent and the agent (acting on behalf of the majority lenders) must negotiate in good faith - typically within 30 days of the change - to determine whether the change “materially alters the commercial effect of the agreement”. If it does, the parties are required to agree amendments that preserve the original commercial intent or otherwise provide lenders with protections comparable to those contemplated at signing. Certain loan agreements further provide that, if the parties cannot agree on the required amendments, the matter is referred to an internationally recognised firm of accountants for a binding determination.

2. Options outside the Agreed Accounting Rules – Where the Agreed Accounting Rules framework described above does not achieve the desired outcome for lenders - for example, where the borrower does not consider there to have been a change in principles or practices, or where lenders wish to adopt additional approaches alongside that framework, a number of potential documentary protections are available:

(a) Information miscellaneous – Loan agreements typically include a clause titled “Information: miscellaneous”, which gives lenders (through the agent) the right to request “further information regarding the financial condition, assets and operations of the Group (including any requested amplification or explanation of any item in the financial statements, budgets or other material provided by any Obligor)”. This provision is useful because it allows lenders to seek clarifications or amplifications to assess any discrepancies in the financials. Where a clear error is identified, lenders and the borrower should ideally be able to resolve the issue through good faith negotiation. However, if the figures remain disputed, this right does not, in itself, provide a mechanism for resolution.

(b) Continuing EoD? –

(i) Most mid-market loan agreements include an access right. This is usually triggered following the occurrence of an EoD - in some deals it applies to any EoD, while in others it is limited to material EoDs. At the more lender-friendly end, the right can also be exercised where the Agent “reasonably suspects” an EoD is continuing or “is reasonably likely to occur.” The right gives the lenders, the Agent, the Security Agent and their professional advisers: (A) free access to the premises, books, accounts and records of each member of the Group; and (B) the ability to meet with senior management to discuss the EoD and the steps being taken to remedy it. This right is intrusive and rarely exercised. When it is used, it tends to be in situations where the relationship between the lenders, the borrower and the sponsor is already strained. Typical scenarios include concerns that covenant miscalculations have persisted across several reporting periods, a lack of timely engagement by the borrower or sponsor in addressing lenders’ questions, weaknesses in reporting quality (such as the absence of supporting calculations), or situations where auditors have declined to sign off on the annual financial statements. In practice, this contractual right operates more as a stick to encourage compliance than as a tool lenders actually deploy.

(ii) If an EoD is continuing, lenders may, as a condition to granting a waiver, require:

(A) amendments to the loan agreement to reflect the change in accounting principles or practices so as to preserve the original commercial intent or otherwise provide lenders with protections comparable to those contemplated at signing;

(B) resubmission of compliance certificates previously delivered based on revised financial figures. This allows them to test whether suspicions about overstated figures are correct (please see more on this in paragraph 3 below); and/or

(C) replacement of certain members of the management team, in particular the chief financial officer. This is an extreme measure and is rarely invoked, but it can be justified where lenders have lost confidence in the accuracy or integrity of the borrower’s financial reporting. The chief financial officer is often the focus, given their central role in preparing and certifying financial information and compliance certificates. In these circumstances, lenders may require that a replacement be appointed with appropriate experience and credibility, sometimes with input or approval rights in favour of the lenders.

(ii) Where an EoD is continuing, borrowers are typically incentivised to cooperate to avoid the risk of enforcement proceedings, and lenders can use the waiver process as a point of leverage to secure additional protections or clarifications that might not otherwise have been achievable at signing.

(c) Annual financial statements – Where the lenders and the borrower continue to dispute the financials and the bases upon which they have been prepared, reliance can ultimately be placed on the audited annual financial statements. These statements, prepared in accordance with established accounting standards and verified by an independent auditor, should provide a definitive reference point against which the accuracy of the monthly and quarterly figures can be assessed. While they are not a perfect solution, given they are only produced annually and are provided several months after each financial year, they nonetheless serve as a reliable benchmark for resolving disputes as to the integrity of the borrower’s interim reporting.

3. Incorrect figures – If, through one of the options outlined above, it becomes apparent that the reported EBITDA figures have been overstated, lenders may require the previously delivered compliance certificates to be resubmitted. Where those revised certificates indicate covenant breaches, lenders may then decide whether to grant waivers of the breaches at that time. The rationale for this exercise is twofold: (i) to confirm that the borrower’s financials are being reported in accordance with the basis agreed at signing, thereby preserving the commercial intent of the deal; and (ii) to provide lenders with additional bargaining power where covenant breaches are identified, enabling them to negotiate amendments, enhanced reporting undertakings, and/or other protections in exchange for granting waivers.

4. Conclusion – In an ideal world, concerns would be resolved through good faith dialogue between the contracting parties. Where that is not possible, loan agreements provide lenders with a range of tools to test and, where necessary, challenge reported numbers. Used thoughtfully, these protections help ensure that financial reporting remains consistent with the agreed basis at signing and that the commercial balance of the deal is preserved.

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