

## SECTOR IN-DEPTH

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## Leveraged Loan Covenants - North America

# Default conditions, loan investors' last bastion of protection, are becoming a rarity

- » **Default conditionality is more crucial than ever in the era of cov-lite.** When leveraged loans offered maintenance covenants, lenders could rely on periodically tested covenants to provide some assurance about the financial health of their borrowers. With "covenant-lite" loans dominating the market and default conditions falling by the wayside, further credit deterioration can occur without foreknowledge or consent of lenders.
- » **Default conditionality is fading away, allowing borrowers to take actions in default, or even following an event of default, while lenders bear the risk.** The most protective loan provisions only allow borrowers to access key carve-outs if there is *no default or event of default*. But this level of conditionality and the protection it provides is becoming a rarity. An increasing number of loan provisions require only that there be *no event of default*, granting the borrower access to carve-outs while in default (a default is a breach that matures into an event of default if not cured or waived within time limits; an event of default permits lenders to exercise remedies). Some loans go further, dispensing with conditionality altogether and allowing borrowers access to certain carve-outs even if an event of default exists.
- » **Conditionality on restricted payment carve-outs is bad; conditionality on other covenant carve-outs is worse.** Key carve-outs allowing restricted payments are more likely to be subject to some form of default conditionality than those carve-outs permitting investments, debt incurrence or debt prepayment. But many loans provide no protection at all for general RP carve-outs (44%) or ratio-based RP carve-outs (29%), respectively. Conditions limiting access to leveraging and investment carve-outs are worse. 96% of general debt carve-outs and 64% of general investment carve-outs are not subject to any default conditionality. The increased market scrutiny of investment-fueled asset stripping calls into question the practice of allowing investment covenants to be more permissive than RP covenants. (See [Borrowers push investment capacity to the brink and telegraph their intention to use it, March 2019.](#))
- » **Builder basket access is subject to stronger conditionality than other carve-outs, but this protection is being challenged in aggressively negotiated deals.** All loans apply some conditions to builder basket access when used for restricted payments (either "no default" or "no event of default"), but 14% of loans apply weaker standards when accessing the builder basket to make investments or debt prepayments. Current deals show similar protections are being challenged in the high-yield bond market, and may be susceptible to change in the loan market as well.

## Default conditionality is more crucial than ever in the era of cov-lite loans

When leveraged loans offered maintenance covenants, lenders could rely on one or more periodically tested covenant to provide some assurance about the financial health of their borrowers. But financial maintenance covenants can no longer be relied upon in the current generation of loans, which are predominantly covenant-lite. The incurrence covenants that limit restricted payments (RPs), investments, junior debt prepayment and debt incurrence used to backstop maintenance covenant protections, but are now the front line of defense for lenders in cov-lite deals.

"No default" conditions on covenant carve-outs provide the last refuge for lenders whose investments may be at risk. If borrowers are unable to take certain actions because they are in default, value will be preserved while issuers are forced to reach out to their lenders for consent. Without such conditions, the borrowers are free to act without providing a last warning or passing one last control point, and their credit could further deteriorate without foreknowledge or consent of lenders.

## Default conditionality, lenders' last bastion of protection, is becoming a rarity, allowing borrowers to take actions in default while lenders bear the risk

Loan covenants historically required that there be no default or event of default as a condition for borrowers using the carve-outs to take various actions. The most protective provisions only allow borrowers to access carve-outs subject to "no default or event of default" (often referred to simply as "no default"). This means that borrowers are prohibited from taking specified actions both at the default stage (earlier) as well as at the event of default stage (later), as shown in Exhibit 1.<sup>1</sup>

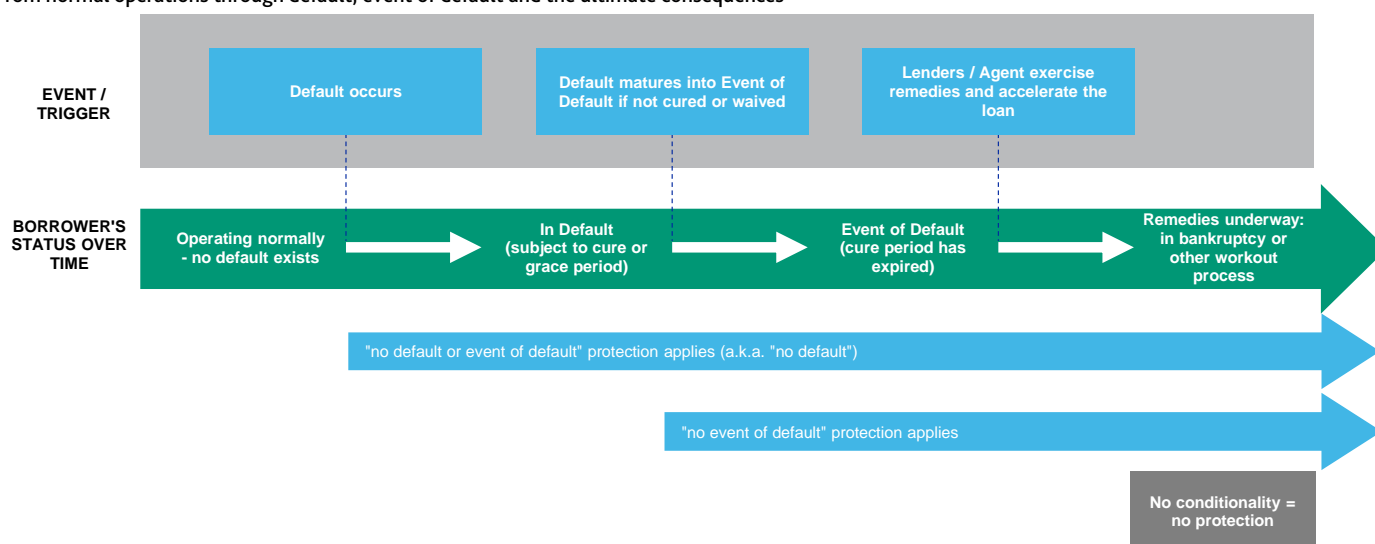
This conditionality allows lenders to exercise tighter control over borrowers. It places the onus on borrowers to resolve (cure) the default or otherwise renegotiate terms to restore carve-out access. But this level of protection is becoming a rarity as more loans either weaken or eliminate conditionality requirements for key carve-outs.

In the absence of such conditions, borrowers are permitted to utilize carve-outs even if they are in default, or, in some cases, even if there has been an event of default.<sup>2</sup> When borrowers can make restricted payments, investments, junior debt prepayments or incur new debt even after defaults occur (and without paying consent fees), lenders are sidelined and can only hope for a satisfactory outcome.

Exhibit 1

### The default progression

From normal operations through default, event of default and the ultimate consequences



Source: Moody's Investors Service

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Borrowers have successfully argued that their access to covenant carve-outs should not be impaired due to a procedural misstep that will be quickly be remedied. This approach can be seen where access to covenants is conditioned upon “no event of default,” where an unmatured default is no impediment to borrower's incurrence.<sup>3</sup> However, such a default can mature into an event of default if the underlying breach is not cured within an agreed upon time frame. Depending on the cause, such a default may be an indication of stress on the borrower.

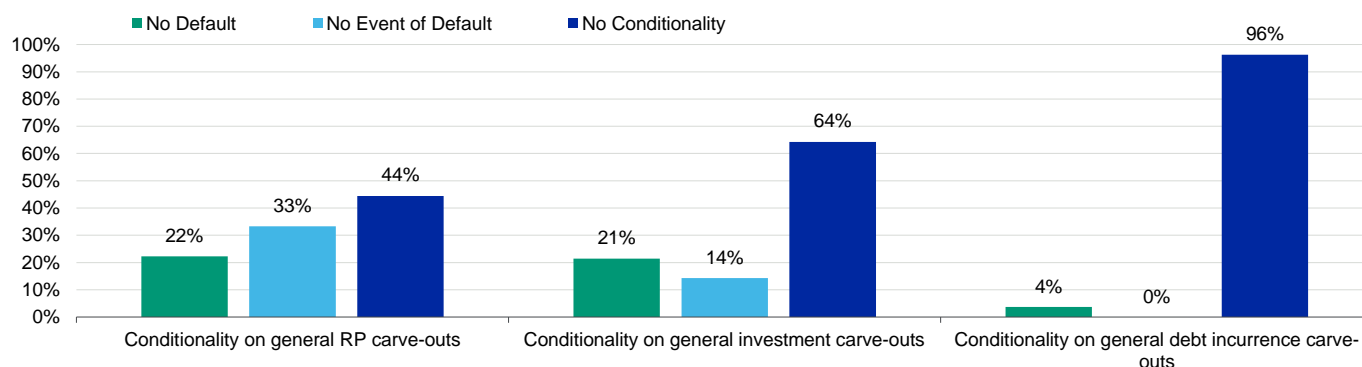
Several types of common defaults can mature into an event of default if not cured. These include the failure to deliver unqualified, audited financials on a specified schedule; failure to maintain credit ratings (to be rated, not to achieve specific ratings - subject to reasonableness limitations); maintenance of intellectual property and other collateral; fulfillment of further assurances provisions; compliance with environmental laws and regulations; compliance with the use of proceeds covenants; participation in a quarterly lender meeting; general compliance with laws and the failure to perform other terms under the credit documents (other than those which immediately trigger an event of default, such as a payment or bankruptcy default).

If the default is an early sign of stress on the borrower, there may be an elevated risk of “Hail Mary” transactions, or last-gasp value extractions for the benefit of the owners. These are precisely the type of transactions over which lenders would want to have the final say, by exercising consent rights through negotiated amendments or waivers, and collecting fees in exchange for such consent. Lenders forfeit this control when they relinquish “no default” conditions.

### Conditionality on restricted payment carve-outs is bad; conditionality on other covenant carve-outs is worse

Exhibit 2

#### Conditionality protections on general carve-outs Breakdown by % of deals

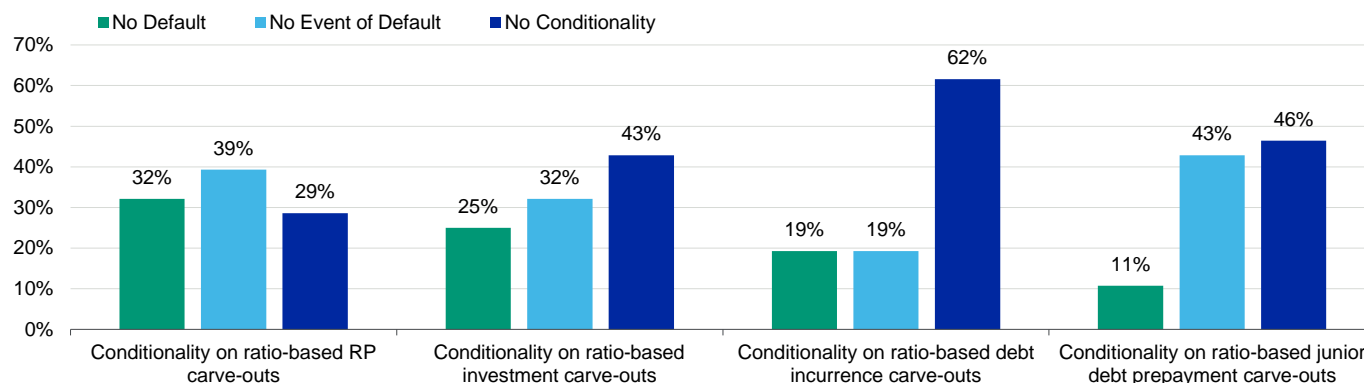


Source: Moody's Investors Service

Exhibit 3

**Conditionality protections on ratio-based carve-outs**

Breakdown by % of deals



Source: Moody's Investors Service

General carve-outs and ratio-based carve-outs are two key sources of covenant flexibility. Access to these carve-outs is likely to be subject to tighter conditionality under the restricted payment covenant than under investment or leveraging covenants. Even so, many loans provide no protection at all for general RP carve-outs (44%) or ratio-based RP carve-outs (29%), respectively (see Exhibits 2 and 3).<sup>4</sup> If conditionality standards limiting RPs are bad, conditionality standards limiting investment, debt incurrence and debt prepayment covenants are worse based on the protections afforded in their general and ratio-based carve-outs. Most strikingly, 96% of loans allow access to the general debt incurrence basket, and 64% of loans allow access to the general investment basket, without meeting any default conditionality standard.<sup>5</sup>

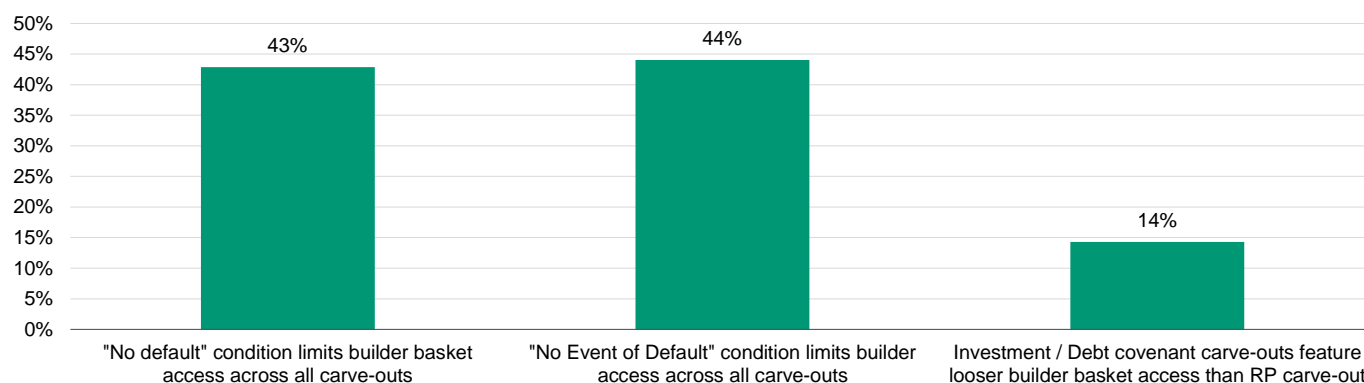
This relaxing of standards reflects the long-held belief that investments, in particular, pose less risk to investors than restricted payments because investments would presumably be accretive to the business and not simply transfer value beyond the reach of creditors. Given investors' concerns following recent investment-fueled asset stripping transactions, the risk that investment transactions can facilitate material collateral leakage calls into question the practice of allowing easier access to investment carve-outs than would be permitted for RPs. (For more information, see [Borrowers push investment capacity to the brink and telegraph their intention to use it, March 2019](#) and [As Stressed Retailers Weigh Asset Transfers, Recovery Rates Risk Taking Hit, May 2017](#)).

## Builder basket access retains stronger conditionality than other carve-outs, but this protection is being challenged in aggressively negotiated deals

Exhibit 4

**Some degree of protection always applies when making RPs from the builder basket**

Investments and debt prepayments usually follow suit



Source: Moody's Investors Service

Builder basket access retains the strongest default conditionality provisions. The "builder basket" is a carve-out that grows larger over time with accumulated consolidated net income or excess cash flow, that the borrower can use to make restricted payments, investments and junior debt prepayments. 100% of deals feature either strong form (no default) or weak form (no event of default) conditionality when using builder basket proceeds to make restricted payments.

While investors have clung to conditions limiting builder basket access to make RPs in both loans and bonds, this conditionality is under attack and was eliminated in one recent bond ([American Airlines Group Inc. Covenant Quality Post-Sale Snapshot](#), 10 June 2019) and may be eliminated in another bond currently in the market ([Sirius Computer Solutions, Inc. Covenant Quality Pre-Sale Snapshot](#), 19 June 2019).<sup>5</sup> More widespread challenges to the protection may follow in the loan market.

In a typical loan, the same conditionality standard applies no matter what the builder basket proceeds are being used for, although exceptions are appearing. 43% of loans apply the robust "no default or event of default" protection uniformly across all three covenants, and another 44% apply the diminished "no event of default" protection uniformly across these three covenants (see Exhibit 4). The remaining 14% of deals featured inconsistent standards, with weaker or nonexistent conditions for investments or prepayments of junior debt. (For examples, see recent loans from [CSC Holdings, LLC](#), 7 February 2012, [Equitrans Midstream Corporation](#), 31 December 2018, [Tenneco Inc.](#), 30 October 2018, and [Select Medical Corporation](#), 26 October 2018).

## Moody's related publications

- » [Protection remains stubbornly weak and shows no sign of improving in 2019, April 2019](#)
- » [Borrowers push investment capacity to the brink and telegraph their intention to use it, March 2019](#)
- » [Convergence of bonds and loans sets stage for worse recoveries in the next downturn, August 2018](#)
- » [Despite new "blocker" protections, J.Crew style asset transfers still a risk, May 2018](#)
- » [As Stressed Retailers Weigh Asset Transfers, Recovery Rates Risk Taking Hit, May 2017](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

## Endnotes

- [1](#) Some events triggering a default may result in an immediate event of default.
- [2](#) The most aggressive loan provisions eliminate default conditionality altogether, allowing the borrower to access carve-outs following an event of default even as lenders are already entitled to exercise remedies. While other considerations ameliorate this risk (including fraudulent conveyance claims, bankruptcy courts and the effective exercise of remedies), the negotiated loan terms continue in effect following an event of default, permitting access to the carve-outs by the borrower. Notably, the exercise of remedies typically requires agent action on behalf of the required lenders. Any discord within the lending syndicate about how best to address the borrower's event of default could delay further enforcement actions.
- [3](#) A default is a type of contractual breach by the lender. While some breaches are so severe they immediately result in an event of default, other breaches (a.k.a. "defaults") will only mature into an event of default after a specified period of time if the default is not cured by the borrower or waived by the lenders within that time frame. An "event of default" authorizes lenders to enforce contractual remedies following a borrower's critical failure under the loan document.
- [4](#) The data for exhibits 2, 3 and 4 come from a sample of the 28 loans most recently scored (for inclusion in the Loan Covenant Quality Indicator), with closing dates from 2H 2018 and Q1 2019
- [5](#) Some carve-outs reflected in this report as featuring "event of default" conditionality are actually weaker, being limited to conditions for payment or bankruptcy events of default. For statistical purposes, "payment or bankruptcy event of default" is considered a subset of "event of default" conditionality and merged into the event of default data.
- [6](#) We note that Sirius Computer Solutions, Inc. has a concurrent loan offering in the market; the covenants team does not publicly disclose terms of private loans.

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