CLEARY GOTTLIEB

Latest in European Leveraged Finance – Equity Cure Clauses

Evolution of the equity cure provision

Equity cure provisions have long been one of the key negotiated provisions in a leveraged finance deal. While a breach of, say, the negative pledge can be avoided by monitoring the usage of baskets (and in case of an inadvertent breach, could be fixed by having the offending security interest released), a breach of a financial covenant is largely outside of the control of the borrower and, if it occurs, there is no way to 'fix' it in the absence of specific cure language.

In principle, equity cures are straightforward: they permit the sponsor to inject cash into the borrower in order to enable the borrower to meet its financial covenant test when it otherwise would not have. That cash must be received by the borrower within a short period after a financial covenant breach. When it is received, the financial covenants are re-calculated, treating the cure payment as having increased EBITDA, increased cashflow and/or reduced debt. In practice though, equity cures have grown more complex as they have evolved, and require the parties to agree on a range of points:

— Should there be any limits on how many equity cures there can be?

— Should there be any limit on how much a cure payment can be?

— How should the cure payment be accounted for when re-calculating the financial covenants?

— How should that equity injection impact other provisions in the loan agreement?

— What should the borrower be obliged to do with the proceeds of a cure payment?

LIMITS TO THE CURE RIGHT

Lenders want to ensure that the cure right is not continually used to mask an underlying problem with the borrower's business instead of just helping the borrower address a short term performance dip. They fear that the sponsor could endlessly cure the financial covenant, while the borrower's business (which is the underlying collateral for the lenders' loan) deteriorates to the point at which a refinancing at maturity becomes impossible.

The most common limitation on equity cure rights is a hard cap on both the total number of times a cure right can be exercised during the life of the deal, and the maximum permitted frequency of such cure. Deals in the past year have capped the maximum number of equity cures at between four and five times in total. The traditional restriction on frequency is to prohibit cure rights from being used on consecutive test dates. An alternative, more borrower-friendly, formulation is to prevent the cure right from being exercised more than twice in any four consecutive fiscal quarters. Some facilities permit an unlimited number of equity cures if the proceeds are used to pay down borrowings under the RCF (where the RCF is the only beneficiary of the covenant).

One way to get around these limits would be to 'over-cure' – use a single cure right to inject more cash than is needed to cure the specific default, and allow the borrower to carry any excess forward for future test dates. In many deals, an overcure is explicitly prohibited, or in some cases an overcure is permitted so long as the proceeds do not count towards EBITDA. In other cases, overcures are permitted, but a different regime applies to what the borrower must do with the amount of the overcure (see "How to spend it").

ACCOUNTING FOR THE CURE

To cure a breach of the leverage ratio (which is the most common and, in the current leveraged loan market, often the only financial covenant), the borrower will either have to reduce its debt as of the test date, or increase its EBITDA for the test period. Hence, an equity cure clause will specify that the leverage ratio will be re-tested after receipt of the cure payment, with one of those two things being deemed to have happened.

Because of the multiplier effect, it will be more advantageous to the sponsor if the cure payment increases EBITDA. For example:

— Assume debt is $50m and EBITDA is $10m, to give a leverage ratio of 5:1.

— If the sponsor wanted to reduce the leverage to 4:1, it would need to inject a $10m equity cure if the payment is deemed to reduce debt.

— If the cure payment is instead applied to increase EBITDA, the sponsor would only need to inject $2.5m to get the leverage down to the same level.

Ordinarily, the receipt of cash by the borrower would operate to reduce the debt element of the leverage ratio, because leverage ratios are usually tested net of any cash on the balance sheet. That is how the majority of equity cure clauses in European deals have worked historically. Recently, however, it has become commonplace in the European TLB market to allow the borrower to deem cure payments as having increased EBITDA for the relevant period, consistent with the U.S. leveraged loan market practice.

The provisions will also typically specify that the cure payment is given effect solely for the purposes of the financial covenant calculation. There are a number of other provisions in the facility agreement (such as margin ratchets, debt incurrence tests and dividend blockers) which lenders argue should be calculated based on the borrower's actual leverage ratio without giving effect to the cure. Similarly, lenders generally argue that any baskets that are increased based on the amount of new equity injections not be affected if those injections represent equity cures. In very few instances, sponsors have succeeded in having cure amounts count towards other provisions in the facility agreement if the cure amounts have been applied in repayment of the loans. It is also established market practice that cure amounts received in respect of a specific fiscal period should be included going forward for any financial covenant calculation that includes that fiscal period.

HOW TO SPEND IT

In addition to legislating for how the financial covenants should be re-calculated following a cure payment, the equity cure provision will also specify what the borrower must do with the cash received. The question here is whether some or all of the money must be used to repay the debt. The lenders will argue that the whole point of a cure mechanic is to bring the capital structure back in line with where the loan agreement says it should be, so there should be some de-leveraging. The counter-point is that if a cure is needed, it would be more appropriate to leave the funds with the borrower to cover any liquidity needs. A middle ground struck in some deals is to require a repayment with half of the cure proceeds, with the other half remaining at the borrower's disposal. Other formulations permit the borrower to reduce RCF outstandings without permanently reducing commitments, which is very favorable to the borrower as it may subsequently redraw the same amounts under the RCF.

Similarly, a recent borrower-friendly development in the European loan market is to permit a cure of the financial covenant by bringing down the RCF outstandings to a level where the financial covenant would not have sprung into effect.

Whatever formulation is decided, all parties should ensure that there are no other provisions of the loan agreement that could be inadvertently triggered by an equity cure. For example, it is critical to ensure that equity cure proceeds do not increase 'Excess Cashflow' for the purposes of the mandatory prepayment. If they do, any victories the sponsor wins in negotiating not having to prepay the facility with equity cure proceeds will be lost.

WHEN CAN YOU CURE?

Lenders will typically proscribe a cutoff time for receiving an equity cure following the delivery of the borrower's financial statements. This period can range from 10 to 30 days. Borrowers should be careful to ensure that this period is long enough to complete the practicalities of an equity cure. The sponsor may need to make some decisions about how to structure a cure payment so as to (among other things) optimize any tax treatment. It will also likely have to get cure payments approved by its investment committee, which can often take longer in situations where an investment is under-performing the model.

A traditional formulation of the equity cure clause cures a default after it has occurred. This technically permits the lenders to exercise their remedies in the period from the date the financial statements are delivered until the cure is actually exercised. Borrowers will therefore want to make it clear in the loan documentation that the financial covenant default does not ripen until the period for making the cure payment has fully expired.

Disputes sometimes arise with the lenders around the treatment of "preemptive" equity amounts, and whether they fall within the definition of an equity cure. Parties are advised to include express language when crafting equity cure provisions to ensure that amounts injected to preempt a financial covenant default receive the same treatment as equity cure amounts. It is typical for lenders to require that such amounts be notified to them as "cure amounts" when advanced in order to receive the required treatment under the debt documents.

DEEMED CURES – TWO STRIKES AND YOU'RE OUT?

Some deals have a "deemed cure" provision, which provides that a breach of the financial covenant is deemed to be cured if the borrower brings the financial covenant back into compliance on the next test date. The idea behind this is to avoid the situation where the borrower ends up in limbo: the financial covenant is breached but the lenders neither waive nor do they enforce their rights.

This seeks to take advantage of a situation where the lending syndicate is made up of a diverse group of lenders, among whom it is not possible to achieve consensus on the enforcement strategy. Remember that typically you need to have majority lender consent in order to accelerate a syndicated loan – that will either be more than two thirds (as is typical for European loans) or, at the very least, a simple majority (as per the U.S. standard). However this deemed cure provision is not without risk – it may force the lenders to take unwanted enforcement action to keep the default alive in a situation where they may otherwise be prepared to wait and negotiate a restructuring.

Similar to a deemed cure provision is what is called the 'Mulligan provision', which is rare in the leveraged loan market (though not uncommon in the investment grade market). It gives the borrower a second chance at meeting the financial covenant in the following test period in the event that it breached it in the first test period. The lenders are prevented under the Mulligan provision from declaring a default until the borrower has breached the financial covenant a second time.

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DEAL CHECK LIST

1. Does the financial covenant Event of Default have a grace period permitting an equity cure? ☐
2. When can you cure?
   - Preemptively? ☐
   - Once a Default has occurred? ☐
   - Once the fiscal quarter has ended? ☐
   - From the beginning of the relevant fiscal quarter? ☐
   - How long does the sponsor need to structure and approve a cure payment? ☐
3. How often can you cure?
   - Can you make cures in consecutive test periods? ☐
   - How many cures over the life of the deal? ☐
4. Can you overcure? ☐
5. How do you allocate equity cure amounts?
   - To increase EBITDA? ☐
   - To increase cashflow? ☐
   - To reduce the debt? ☐
   - At the borrower's option? ☐
6. Does the equity cure amount count?
   - When calculating the financial covenant in future test period? ☐
   - When making covenant calculations other than the financial covenant? ☐
   - When calculating "Excess Cashflow"? ☐
7. Are you obliged to make a prepayment with the cure proceeds?
   - With the entire equity cure amount? ☐
   - In an amount sufficient to meet the financial covenant test? ☐
8. Can you still borrow under your RCF during the cure period? ☐
9. Is an event of default triggered during the cure period? ☐
10. Is there a deemed cure provision? ☐
11. Is there a "Mulligan" provision? ☐

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