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FINANCIAL COVENANTS - AN ANALYSIS ON COMPLIANCE LOAN AGREEMENTS

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INTRODUCTION

The immense impact that COVID-19 has had on not only our everyday lives but the economy, in general, could not have been anticipated by anyone. Increased liquidity was crucial for some firms, but it was just as necessary to understand existing lending arrangements and how they were influenced by the numerous initiatives that the government has initiated for businesses at such volatile and difficult times, or elsewhere. It soon became apparent to the lenders that it could be harmful, as many borrowers found themselves in breach or possible breach of agreements without fault of their own and were unable to remedy those violations immediately, to take a tight approach to the precise requirements of the loan agreements and other financial documents.[1]

As we move into this next phase of the pandemic, for the first time since the lock-down measures were implemented, the easing of measures with non-essential stores has now finally reopened for business, in order to achieve realistic and fair results for those concerned during these difficult times, this paper examines how current lending arrangements have been affected, how lenders (and private banks) have been affected.

I. HOW HAVE LENDERS (AND PRIVATE BANKS IN PARTICULAR) RESPONDED TO THE COVID-19 CRISIS AND WHAT ELSE WOULD NEED TO BE TACKLED IN THE COMING MONTHS TO ACHIEVE REALISTIC AND FAIR RESULTS FOR ALL STAKEHOLDERS?

[1] In May 2020, the Cabinet Office and Infrastructure and Projects Authority published non-statutory guidance on responsible behaviour in the performance and enforcement of contracts that have been affected and impacted by the COVID-19 pandemic.

FINANCIAL COVENANT' IN THE LIGHT OF COVID-19

Historically, lenders have depended on a range of financial agreements to enable them to monitor the borrower's financial condition and to recognise signs of suffering at an early stage and offer them a seat for restructuring negotiations. However, the lenders have increasingly abandoned some of the protections provided for under financial agreements. Each borrower uses a list of financial agreements to warn lenders about the deterioration of financial results. If these deals are breached, lenders may bring a borrower to their table in order to address issues of general or inefficiencies. As a result of the measures taken to tackle the pandemic, several corporations have experienced a significant and sudden decline in sales that will impact businesses' ability to fulfil performance covenants.

- There are also concerns around value covenants. And, several companies have had, or will soon have, to ask their lenders for waivers of some or, probably, all of the financial covenants in their loan agreements.

Financial agreements broadly measure the reliability of the lender or the performance of the business that serves the loan through the credit contract. Covenants are designed to measure the value of the protection of a lender against an appraisal of value on a given day, while covenants over a period of time look back or forward to see if the borrower's company showed signs of stress. COVID-19 has differently affected each sector. For some, such violations can take place as recession continues and sanctions can modify or ultimately quickly adjust. Certain firms are either in default or are not due to a loss quite soon as financial arrangement breaches. In such a complex situation, the dilemma both for lenders and borrowers is to control or prevent such violations.

THE PANDEMIC'S POTENTIAL EFFECTS ON FINANCIAL COVENANTS (BREACH)

For example, if a wealthy real estate borrower is bound by the following financial covenant stipulated in his loan agreement: to guarantee that the value of his real estate is z-times greater than the debt he lent, this agreement was now intended to deal with a borrower who made a bad investment decision on real estate or otherwise mismanaged that property. If the property falls in value — maybe because of a fire or because the land creditor plans fall through — then a financial covenant may be violated.[2]

Almost inevitably, a breach of agreement causes creditor banks to announce a special form of breach of contract called a Case of Default. Financial covenants come in two forms:

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[2] Leibniz: A Contribution to the Archaeology of Power is out with Edinburgh UP in 2021.

- "Maintenance covenants" implies that a breach is an event of default triggering immediate repayment of the debt.
- "Incurrence covenants" implies that the borrower is restricted from taking up new debt if by doing so the borrower would breach a covenant.[3]

Although it is common for banks to negotiate a restructuring at this point, they are moving into the negotiation, speeding up the process. Acceleration can mean that banks will become entitled to interrupt all potential borrowings and claim repayment of all current borrowings.

EXCEPTIONAL ITEM: COVID 19

Carve-outs in definitions of financial covenants typically allow "exceptional items" to be put in and their scope is usually not exhaustive. It can include language along the lines of, "means any material items of an uncommon or non-recurring nature representing gains or losses including gains or losses that occur on ...," [4] followed by a non-exhaustive example list. Therefore, the concept of exceptional items is usually subjective, which can be very critical as deciding what constitutes an exceptional item can have an effect on compliance with the covenant and affect the trust of creditors, public statements, and auditors involved in assessments. The shock associated with COVID-19 is (or, ideally at least, would be) rare or non-recurring in nature while deciding on the magnitude of such changes poses an unparalleled obstacle. The full effect of the pandemic must be quantified and effectively portrayed by creditors, according to the real underlying financial results and market role.

a. Infringement of any payment duty and/or other covenants (after the expiry of any applicable grace periods), including
b. financial and notice covenants or failure of any representation to be right in all material respects when rendered may cause a default case under the appropriate lending documents.

PRE-EMPTIVE STRIKES:

Borrowers and lenders (especially private banks) will be required to review their lending paperwork in order, among other things, to review the financial agreements, recovery periods, and potential clauses in respect of breaches of assurances and guarantees, obligations and clauses for notice, taking into account the fact that these complicated pro documents are being resolved.

1. EBITDA is the most popular financial performance metric as it is the best proxy for cash flow profit and loss account production. EBITDAC (Earnings before interests, taxation, depreciation, amortisation and COVID-19) is the concept of the attempt to reach a company's COVID-19 adjusted cash flow capacity[5].

[3] COVID-19: Managing Financial Covenants in a Downturn, dated 24 March 2020
[4] COVID-19 Practical Considerations: Impacts for borrowers on financial reporting and covenants, Arthur Cox
[5]Key steps organizations should follow in order to avoid potential breaches of financial covenants.

2. In order to decide whether the additions (such as cost savings, synergies, or other accepted initiatives) can be introduced to mitigate the size of the collateral effect resulting from decreased net income or EBITDA, borrowers and lenders must carefully review their financial arrangement (such as consolidated net income and consolidated EBITDA and related terms) in loan documents.
3. Implications outside conformity with the financial arrangement include contractual conditions for asset sales and exceed cash flow, some treaty settlements (such as additional obligations and incurrences of obligations) and likely price deductions.
4. Investors and their owners must accept precautionary equity injections to ensure compliance with the arrangement and assign the same profits as equity amounts in the resolution of the breach of the arrangement as potential exceptions or changes to covenants which are likely to be overridden.[6]
5. Although exemptions and changes can be beneficial for possible non-compliance with one-off contractual arrangements for borrowers, borrowers in directly affected industries with some unique issues may need to try to reinstate their covenants and other loan agreements clauses or seek alternative financing.
6. Borrowers and lenders will also have to scrutinise their loan agreements and review any financial arrangements (including financial conditions descriptions), lengths of grace and any clauses for breach of obligations, liabilities and requirement of transparency in such documents, among other matters.

II. WHETHER FORCE MAJEURE EVENTS AS THE ONGOING PANDEMIC CRISIS, I.E., COVID-19 TYPICALLY GIVE ANY RELIEF FROM REPAYMENT OBLIGATIONS?

If a borrower reaches a loan agreement, he agrees with certain terms and conditions which must be complied with by him to continue such a loan in compliance with the negotiated conditions, one of which is a financial agreement. Financial covenants are designed so as to make it possible for the lender to weaken the borrower's financial power. If these contractual agreements are broken, the creditor may contact these creditors to fix contractual problems and loss. The financial arrangement is usually an arrangement to which the creditor intends to represent "more reasonably" his underlying business results.[7] Although designed to improve the borrower's motivation to take action to avoid negative results in its corporate finance. These pacts allow the lender, if the borrower cannot or does not take steps to fix the situation, to take compliance

[6] *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (2001

[7] A. Hayes, *Covenant*, <https://www.investopedia.com/terms/c/covenant.asp>, last accessed on 20/09/2020

measures.[8] If such an arrangement is breached, the lenders shall have the right to use a draconian right, i.e. immediate refund of all loan obligations, to revoke this duty from the applicant.

Covenants in loan agreements are broadly divided into 2 categories[9]:

AFFIRMATIVE COVENANT

A positive agreement is a provision requiring the creditor to take certain measures. A positive agreement is a provision. For example, maintenance of certain insurance levels, provision of a copy of financial statements, prompt maintenance of account books, etc.

If an affirmative agreement is violated, an absolute default is generally presumed. Some agreements which include provisions that allow the creditor that correct his violation for a certain grace period. The lenders shall alert the defaults if not resolved and request the repayment of the main amount and its interest immediately.

NEGATIVE COVENANT

The creditor shall not conduct or refuse to perform any acts that will impair its reputation and the ability to repay its current obligations. The most popular example is to hold the financial ratios equal. For example, lending structures require a debt-to - equity ratio and a certain proportion of capital expenditure, so the borrower should not burden himself more than he is willing to afford to do.

Then there are **bond covenants,** which are made for the protection of the interest of both the parties and are the bond's indenture, which is the binding agreement or contract between two or more parties. In case of a default in the bond covenant, it is to be treated as a technical one and its common penalty is the fall of the bond’s rating by credit rating agencies which will affect the goodwill of the borrower & will shift the potential investors and it may also result in mounting issuer’s borrowing costs.

For instance, **Moody** is one of the major credit rating agencies in the United States which indicates the consistency in violation of covenants In May 2016, Moody's reported a decline in covenant quality to 4.56 from 3.8 out of 5, (with 5 being the worst). The downgrade is attributed to a high amount of junk bonds being issued, ones with strict covenants that are easier to default.[10]

BREACH OF COVENANT & INDIAN ACCOUNTING STANDARDS

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[8] The COVID -19 Effect on Covenants, <https://home.kpmg/uk/en/home/insights/2020/06/impact-of-covid-19-on-financial-covenants.html> last accessed 20/09/2020

[9] A. Hayes, *Supra* note 1

[10] *Ibid.*

Generally, violation of these covenants gives autonomy to the lenders to demand early repayment of the debt. So to avoid such abrupt contingent liability, borrowers must consider taking measures to identify whether it can or should draw on existing available debt commitments, whether the conditions to borrowing have been satisfied or whether it would be prudent to proactively seek waivers in advance.[11]

The financial arrangement terms and conditions of the loan agreement have little at all to do with the present accountable scheme, which is practiced by the borrower until the Indian Accounting Principles are adopted in compliance with MCA's proposed road map. The situation of breach or violation of financial agreement shall, until the Ind-AS or IFRS are applicable, differ from categorization to ratios and balance sheet power, which will sooner or later affect this liability.

One of the applicable references is Ind-AS 1, i.e. a submission of Financial Statements under which a long-term loan arrangement is broken under respect of some material transaction, and the loan is to be regarded as an existing liability that is again the discretion of the lender not to demand the credit in the next 12 months. The shared understanding of the party in ensuring compliance with the provision is determined what constitutes a 'material understanding'.[12]

IMPLICATIONS OF CORONAVIRUS ON CONTRACTS

The global spread of the Covid-19 epidemic has seriously affected virtually all sectors and shaken the global financial sector. Small businesses suffer adverse consequences and many have filed bankruptcies. And the largest corporations have warned of the adverse situation created by the Covid-19 pandemic. Disruptions in supply chains' continuing to impact production units and the demand for goods and services was reduced as many transport management measures were placed in place to break the virus chain, and it is clear that the earnings produced in the near future will decrease considerably.

The borrowers are going to face greater difficulty in the compliance with any loan agreement obligations including financial covenant and would try to meet the existing obligations by arranging another source of debt financing and thus increased risks for lenders as well as borrowers. The arrangers of debt financings will need to examine the risk associated with Covid-19 on the business of the borrowers with enhanced due diligence including the potential risk involved in the business supply and customer's credibility. It's practical for the borrowers as well as lenders to closely scrutinize and review terms and conditions in their debt agreements or contracts, any financial covenant involved among other things, grace periods, and penalties for breaches of warranties and conditions and notice obligations in such arrangement. Terms like "consolidated net income" and "consolidated EBITDA will have to be considered in the financial

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[11]CA A. Agrawal, *BREACH of Covenants of a Loan – "Classification change" under Ind-AS* <https://taxguru.in/finance/breach-covenants-loan-classification-change-indas.html> last accessed 20/09/2020

[12]CA A. Agrawal, *Supra* note 5 at pg 2

covenants. The organizations may need to assess their existing financial strength and the ability to stretch their operations within the existing resources. The companies may also need to consider their refinance or arrange interim financing or avoid and non-essential and non-significant investments or sell their assets as an alternative to raise money to meet their current liabilities.[13]

FORCE MAJEURE

"Force majeure" is a French phrase which means **"superior force"** and is embodied under sections 32 and 56 of the Indian Contract Actin the Indian laws. It is implicated in certain clauses in contracts that excuse a party's performance as a result of an **Act of God** event that is defined as, or deemed to be, "force majeure."

In the wake of the Corona outbreak, the government has responded by '**stay at home'** or '**work from home'** mandates restricting the transportation and movement of people as well as government units resulting in business and trade constraints as well. One of the other effects is that loan borrowers and their lenders have been issuing the '**Force Majeure Notice'** as an attempt to invoke the force majeure provisions governing under their loan agreements or contracts.

Typically, force majeure events include war, labor strike, natural disasters, terrorism, disruption of supply chains, epidemics, proclaimed national emergencies, and certain proclaimed governmental actions. However, force majeure is a civil law concept, since it is derived from the French civil law system and not a common law concept.[14]

A point here is to be noted that the application of the force majeure event clause would only excuse certain covenant compliances and cessation of work for a period longer than specified in the loan contract or the covenant, failure of which would otherwise customarily be deemed as default under the loan contract, and circumstances which are not in control of such borrower

The force majeure laws in India has been laid down through has the landmark case **Satyabrata Ghose vs Mugneeram Bangur & Co.**[15] and the jurisprudence of the same has been very well

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[13] Shearman and Sterlings, Coronavirus Implications In Loan Documents <https://www.shearman.com/perspectives/2020/03/coronavirus-implications-in-loan-documents> last accessed 20/09/2020

[14] W. K Ihrig, *Loan Documentation: Force Majeure and the Implications of COVID-19,* https://www.lexology.com/library/detail.aspx?g=81892366-a187-4a96-8605-a226dad3e642#:~:text=The%20occurrence%20of%20the%20event%20coupled%20with%20either%20actual%20delay,provided%20in%20the%20loan%20agreement.

[15] Satyabrata v. Mugneeram (AIR 1954 SC 44 at p. 48)

explained by Justice RF Nariman in the case of **Energy Watchdog v CERC (2017[16]).** The following points, in particular, are to be considered if the force majeure clause to be invoked:

- **Force Majeure as a General Concept** - Situations or conditions which are beyond the reasonable control of either party doesn't make them liable under the event or condition that prevents the performance of their obligations as per the terms of the contract.
- **Duty to mitigate the and exercise due diligence** – If such duty has been embodied in the contract, the meaning of 'reasonable diligence' will vary from case to case depending upon the language used in the contract and the relevant circumstances. Moreover, it should also be analyzed whether such duty has been endeavored in the best way possible to mitigate the effects of force majeure events.
- **Foreseeability** – Such an event must be unforeseeable or not reasonably foreseeable.
- **Notice -** Most contracts and agreements are required to notify the other party to invoke a force majeure clause. Sometimes such notice must be sent within the time, if prescribed, to claim the benefits out of it.
- **The burden of proof** – The onus of proof is on the party which has invoked such claim and such provisions are customarily strictly construed by the courts.
- **Absence of Force majeure clause** – If such clause isn't mentioned in the clause then the party can rely on the doctrine of frustration under **section 56 of the Indian Contract Act, 1872.** However, It must be proved that the performance of the particular is impossible and the arrangement intended fundamentally differs from that of at the time of executing such contracts.[17]

In the current context, it should be determined first that whether and in what manner Covid-19 and its outcomes fit into the force majeure definition of financial covenants or loan contracts. The express language of the definition, specified events, its ambit, and context in which such definition has been construed are to be critically analyzed. Or sometimes, the contracts contain the open-ended definitions that capture the general broad meaning and isn't held liable for events outside its purview.

To an extent, there have been huge supply chain disruptions which have stopped the working of various industries resulting in stoppage of all the business operations as a whole hence no revenue has been generated or government response to the same, might create a "material shortage" or be construed as a disruption to transportation which would give rise to a force majeure event.

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[16] Energy Watchdog & Ors. v. Central Electricity Regulatory Commission & Ors 2017

[17] Cyril Amarchand Mangaldas, Coronavirus: Key Legal Issues for India Inc. With Covid-19, <https://www.bloombergquint.com/opinion/coronavirus-key-legal-issues-for-india-inc-with-covid-19> last accessed 20/09/2020

Thus to assert force majeure, a standard has to made that the particular event or COVID-19 in the current situation claimed actually falls into the express contractual definition or applicable clause of the loan contract.

DISRUPTION IN SUPPLY

Covid-19 Pandemic was conducted or is likely to result in postponed, interjected or even terminated outputs under several contracts. The fact that Covid-19 has stopped them from doing so fundamentally, or that they pursue it to use it as a justification for relieving themselves of these obligations, would most likely lead counterparties to postpone or prohibit the fulfillment of their contractual obligations. In view of their non-performance of their supplier, businesses may therefore be not able to meet their obligations under their customer agreements and may postpone or stop meeting their contractual commitments or may even withdraw from them. However, it is highly unlikely that Force Majeure would be a valid defense under each and every contract as different contracts and their governing laws stipulated different meanings for different circumstances.

III. HOW EBITDA HAS EVOLVED IN RESPECT OF FINANCIAL COVENANT IN THE EUROPEAN LOAN MARKET?

In the US leveraged buy-out craze of the 1980s, EBITDA first rose to prominence and has since developed the main metric of leveraged finance transactions around the globe. This issue focuses on the transformation of the European loan market and discusses how, as a result of these developments, financial arrangements and some other guarantees in loan documents have been undermined in recent years.

Financial covenants are financial ratios that act as a mechanism for allocating funds. Influence rights between creditors and creditors. You report the status of the company during the borrowing era. If the state of the company is 'good,' equity investors remain accountable and may also obtain private benefits.[18]

FOUNDATION OF EBITDA

The standard form facilities agreement of the Loan Market Association (LMA) for leveraged acquisition financing transactions includes a number of financial covenants, including; cashflow cover test (being the cashflow-to-debt service ratio); interest cover test (being the EBITDA to finance charges (interest and fees) ratio measured on a gross or net basis); and a leverage test (being an EBITDA ratio to the overall debt measured either grossly).

[18] Structure and Determinants of Financial Covenants in Leveraged Buyouts, Center for Entrepreneurial and Financial Studies (CEFS), Technische Universität München, https://www.econstor.eu/bitstream/10419/48443/1/616636369.pdf last accessed 20/09/2020

The main component of all these tests is EBITDA (the uninitiated can refer to the description at the end of this article), from which the description of cash flow is extracted. This is despite the fact that under either GAAP or IFRS accounting principles EBITDA is not a recognized metric. The above-mentioned financial agreements (known as 'maintenance checks' because they oblige the borrower to maintain a certain degree of financial performance over the life of the loan) are intended to allow lenders to track the financial performance of the borrower against the negotiated financial estimates (known as the base case model) under which the transaction was planned.

In short, the amount of the debt and its service expense are prefaced by the company's ability to meet its goals. Maintenance reviews measure the company's financial results periodically on a rotating 12-month retrospective basis. Any major decreased financial performance in relation to the financial projections will result in one or more financial agreements being infringed. The resulting default case would encourage the lender to speak to the borrower and his financial advisors about what went wrong and how best the borrower can rectify it. The financial pact reviews are therefore intended to be an early warning system for lenders.

The theory is simple and experience also showed that maintenance agreements perform regularly the position they were intended for. Restructuring lawyers will confirm that almost all distressed deals have historically defaulted in the first place because they violated financial agreements, and this breach has enabled lenders to intervene at an early stage. On the other hand, private equity sponsors are understandably trying to avoid a portfolio company breach of their agreements and enable lenders to accelerate the loan potentially and to enforce their safeguard against this default.

SPONSOR NEGOTIATION OF FINANCIAL COVENANT TERMS

The new years have been marked by the introduction of enhanced borrower flexibility and consequently decreased lender power into Europe-wide loan documents for sponsor-sponsored leveraged financing transactions. There are well known explanations for this, the main being a large increase in liquidity on the debt market. Sponsors have been able to gain in this borrower-friendly atmosphere from the rivalry between lenders, debt funds, and banks alike to incorporate documentary terms only for their portfolio firms in the liquid US credit market that have their own roots in a more open and stable world of high-end bonds.

One result was that maintenance financial covenants were replaced by incident checks, generally referred to as 'Cov-Lite' facilities, at the broader end of the European leveraged finance market. For example, by way of instance, a leverage event test will prevent the creditor category from incurring indebtedness until the same indebtedness is incurred on the date of incurrence and the leverage ratio will therefore not exceed the specified amount, taking the new debt into account.

MAINTENANCE oF LEVARAGE TEST

If the facilities include a revolving credit facility ('RCF') in a Cov-lite contract, a residual leverage maintenance test can remain. This would possibly be a "springing" test, and would only be operational during certain times when the borrowers have drawn down an accepted threshold sum of the RCF. In recent years, the RCF drawdown threshold has been subjected to upward pressure. When it was first introduced, at least 25 per-cent was set around the RCF, but now it is typically considerably higher and can be seen as high as 40 per-cent.

While there was pressure from sponsors to drop maintenance tests even in the mid-market, most of these dealings were not made on a cov-lite basis. It is primarily because there is no substantial secondary debt market in the mid-market (and the documentation also limits transfers in any case), so it is necessary for lenders to have financial covenant protection, as they do not have the option of merely selling under-performing credits. In the mid-market, the vast majority of transactions today include just one financial arrangement-the leverage exam-and are frequently referred to as "Cov-loose" transactions.[19]

For the reasons stated above, most lenders take comfort from the continued presence of the leverage test in the documents. However, some of these checks are designed in such a way that they are extremely unlikely to be triggered until such a period when the company goes into default on payment (i.e., it has become unable to pay interest or other loan-related service costs). A panellist commented at the Debt wire Mid-Market European Forum in June, "Frankly, the leverage test is sometimes not worth the paper it is written on these days!"

The downside is that the borrower only has to raise debt which would otherwise be forbidden and not regularly followed up. The borrower must only be checked at the point. If the incurrence test is satisfied at the time needed, the debt should be not reduced, if profits later decline, to breach the leverage ratio. The significance of these disadvantages is not shown by a maintenance leverage test.

EBITDA ADD-BACKS AND OTHER ADJUSTMENTS

EBITDA is, as mentioned above, an accounting fiction in itself. It is an effort to describe and measure the company's "business as usual" income by removing the impact of borrowings, taxation, accounting changes, and one-off events (outstanding items). Since EBITDA does not have a common accounting definition, it must be established for the purposes of a specific transaction and thus leaves accessible to heavy negotiation by itself.

EXCEPTIONS

In fact, what is or is not, in accounting terms, an "exceptional item" can not be completely described by merely referring to the word "exceptional item." Borrowers should look to provide a long list of products that will be handled so as not to minimize EBITDA in order to ensure that

[19] The evolving fiction of EBITDA in the European leveraged finance loans market, <https://www.lexology.com/library/detail.aspx?g=c857e565-75f9-4563-a690-047c326af17b> last accessed 20/09/2020

unique products that affect their earnings will be counted as exceptional items. This list needs consideration as to whether all goods are really suitable. For example, certain sponsors can request that "business as normal" loss-making contracts be regarded as extraordinary products based on the fact that their loss-making existence makes them unique. Alternatively, borrowers can depend on a common concept of exceptional products and benefit from this lack of specificity in order to enable more versatility for themselves. Often capping the number of losses that can be viewed as extraordinary to this function can be reasonable.

PROFORMA ADJUSTMENT

It is likely that a portfolio company will look to acquire additional businesses during the life of the debt facilities and most facilities agreements will contain an incremental facility (usually uncommitted) which is designed to be drawn down to help the business to fund such acquisitions. As a result, the concept of EBITDA changed over time to take into account the potential for an acquisition to be made within a 12-month rolling covenant testing period.

The most common way of doing this is to adapt the concept of EBITDA for the purpose of the leverage test by establishing a description of “proforma EBITDA” to be used instead of plain EBITDA in the leverage test. Those modifications give proforma impact to any acquisition made during the applicable test period. This ensures that a company's earnings gained during the year at any time will be viewed as gained over the entire 12-month span.

Some transactions go further and allow the CFO to increase EBITDA by taking into account the "revenue synergies" that the company expects would be realized as a result of the event in question. Lenders are more cautious about such inclusions on the grounds that sales synergies are more difficult to measure, and therefore more vulnerable to business speculation.

Nevertheless, in recent times, the capacity of the CFO to provide income synergies on transactions has increased, albeit always subject to the types of caps listed above. Whatever is accepted about EBITDA add-backs to a specific transaction, lenders which demand clarity and demand that the borrower clarify and identify in the compliance certificate to be delivered as part of the quarterly financial reporting package where exceptional items and synergies have been included in the EBITDA calculation for that specific test period. Where the company of a borrower is exposed to forex fluctuations, it may also be necessary for the parties to decide how to handle those fluctuations for the purposes of calculating financial definitions. Consistency will be important in this.

THE BROADER IMPACT OF EBITDA

The above changes that may have the effect of improving EBITDA are not applying exclusively to those deals that include a leverage test for maintenance. The creditor would be equally willing to raise the EBITDA amount in the case of a Cov-lite deal for every spring leverage test and for incident testing purposes. In addition, the concept of EBITDA has significance beyond financial covenants, be it maintenance or incidental in nature. To avoid possible value leakage from the community on which the lenders have based their credit appraisal, large-cap and mid-market transactions include negative covenants to discourage companies from making acquisitions; disposal of cash, securities and guarantees, loans, and other operations.

Unless they fall under a set of unique exceptions (colloquially referred to as "permissions") or, failing that, under a specified financial limit or basket, these types of activities would be prohibited. While the basket level will be set by comparison to a fixed sum at the time of signing an agreement, it is now generally agreed that such baskets will rise as EBITDA increases, thus making the further versatility to the creditor. If lenders have agreed that changes may be made to EBITDA for financial covenants purposes, they may find it difficult to argue against the borrower using the adjusted EBITDA (rather than the “real” EBITDA) figure when measuring the expansion of such baskets.

“Beware of misconceptions; it is more harmful than ignorance”

The popular quote by George Bernard Shaw is fitting, although he is unlikely to have foreseen it being used in this specific sense. Potential lenders should ensure that both the concept of EBITDA itself and the positions in the documents where that word is used are analyzed in order to understand how robust the financial measures are. It is then easier to determine, armed with that information, if the risk/reward ratio for that particular deal is an appealing proposition and, in the case of an agreement involving a maintenance leverage test, if that test is capable of meeting the requirements of the lenders for its inclusion and, in the first place, justifying the corresponding price.

CONCLUSION

The response of the lender and approval of these improvements is a vital measure of the complexities of stakeholders and will determine how COVID-19 restructurings develop. The COVID-19 pandemic has negatively impacted the operations of business activities and financial conditions in almost every market and sector globally. As a result, under their current loan documents and any future credit services, borrowers and lenders need to recognize some problems, lenders must look carefully at the underlying business to establish whether or not the problems would have arisen anyway and to act accordingly, in which case most businesses should be looking to agree to short term waivers of such breaches to reset the covenants when they have the information and certainty to be able to do so.

To decide whether or not the issues may have occurred or not and to respond accordingly, lenders must look at the underlying entity,

- In which case certain firms should attempt to at least agree to short-term exemptions to those violations to reset the deals until they have the knowledge and assurance to do so.

Nearly all borrowers are expected to be impacted by the effect of COVID-19 on covenants and the broader lending arrangement. In lender negotiations, whatever the path borrowers take, they will need to assemble a detailed collection of details that explicitly points out the effect on financial results and position. Financial institutions, regulatory agencies, and the state banking regulators view loan modification programs as positive actions that can mitigate adverse effects to borrowers due to COVID-19. The statement also provides that if a loan is otherwise performing, such agencies will not consider "short-term modifications made on a good faith basis in response to COVID-19" to be troubled debt restructurings.

Borrowers and lenders who have checked their loan documents, recognized possible issues that could be triggered by COVID-19, and desired to participate in negotiations on the adjustment of the loan should, first, seriously recommend entering into a pre-negotiation arrangement to secure themselves and provide for a fairly open and frank dialogue between the parties to devise a solution.[20]

[20] Resolution framework for COVID-19 related stress, Analysis of RBI circular dated 6 August 2020 (within Prudential Framework dated 7 June 2019) August 2020