An Overview of Equity Cure Rights

The Loan Market Association ("LMA") model form financial covenant provisions have been fairly widely used in the leveraged market since their publication in October 2006, and in general terms, are useful provisions from both the Lender and the Borrower perspective. There is, however, a key omission, from the Borrower point of view: the LMA provisions do not include any equity cure right, despite the fact that such rights have become almost universal in the leveraged market and are often a key focus of negotiations on financial covenant provisions. This Briefing contains an overview of some of the issues that can arise when negotiating equity cure rights, and considers whether such rights have become sufficiently ubiquitous to survive the effects of the credit crunch.

Introduction

Equity cure rights enable investors or sponsors to provide additional equity, which will be applied as agreed in the documentation, in order to “cure” breaches of the financial covenants applicable to the borrowing group. In recent times (at least, prior to the onset of the credit crunch this summer), the inclusion of an equity cure right in some form has been very common in leveraged financing documentation, although the scope and operation of such rights varies.

If the inclusion of an equity cure right is agreed, negotiations often focus on how any such amounts should be applied (to increase cashflow and/or EBITDA and/or to reduce borrowings), the timing of exercise and the effects of the “cure”. Each of these issues is considered briefly below.

Application of Equity Cure Amounts

Equity cure rights usually operate such that financial covenants will be recalculated on a pro-forma basis for the testing period in which the breach occurs to include any equity cure amounts. To enable the recalculated figures to be determined, the agreement must specify how any equity cure amounts are to be treated.

It is fairly common for Lenders to agree to equity cure amounts being applied to increase cashflow. If the group has a short-term cashflow problem, the application of additional equity to increase cashflow will solve the problem (being extra cash). However, Borrowers will usually also want to ensure that any equity cure amount is applied to increase EBITDA to cure any breach of the leverage ratio (often the key ratio for the purposes of the facility agreement). Lenders traditionally dislike additional equity being added to EBITDA, as it masks, but does not solve, underlying profitability issues. Nonetheless, Borrowers have often been successful in negotiating the right to apply equity cure amounts to EBITDA, most probably for two reasons (in addition to the effects of the bull market). First, Lenders take comfort from the willingness of the investors/sponsors to come to the aid of the group when financial difficulties arise. Secondly, Lenders may benefit from an increased excess cashflow sweep as a result of the additional equity in the group (assuming that the additional equity forms part of excess cashflow subject to the sweep, which very strong Borrowers may seek to resist).
Some Lenders, however, resist the application of equity cure amounts to cashflow and/or EBITDA and instead, argue that equity cure amounts should be applied to reduce borrowings. From a Borrower perspective, this is obviously less attractive, as if the equity cure amount is applied to reduce debt instead of increasing EBITDA, its positive impact on the leverage ratio will be less.

Additionally, if equity is applied to reduce debt for financial covenant purposes, Lenders are likely to seek to have the additional equity either applied directly to prepayment or placed in a blocked account (from which it will usually be released if the financial covenants are complied with for a certain period going forward). Whether Lenders win this point will depend, as usual, on bargaining strength. In these circumstances, Borrowers might seek to argue that equity cure amounts applied to reduce borrowings for financial covenant purposes, rather than being applied to prepayment, should be treated as part of excess cashflow (given that only a percentage of excess cashflow is usually applied to prepayment).

**Timing issues**

The operation of any equity cure right is usually limited in terms of the permitted frequency of exercise and the time frame within which the additional equity must be provided.

Lenders almost always impose a limit on the number of times an equity cure right can be exercised in consecutive periods, the maximum is usually two or three times. It is also customary to apply an overall cap on the number of times the equity cure right can be exercised during the life of the deal, usually somewhere up to around four times.

Investors are usually only permitted a certain window within which to provide additional equity. Equity is typically required to be provided within up to around 30 days of the relevant compliance certificate which confirms to the Lenders the existence of a breach of the financial covenants. Theoretically, there is nothing to stop investors providing additional equity prior to the date of the relevant compliance certificate in order to “cure” a potential breach before it happens, although this is not always expressly stated in equity cure provisions. The concept of prevention as well as cure should not be controversial from the Lender perspective if the general concept of an equity cure right is agreed, and it is advisable to deal with the issue expressly in order that there is no argument as to the manner of application of additional equity provided in such circumstances. This might be achieved by including any additional equity provided during the period as part of the definitions of EBITDA/Cashflow etc. in the financial covenant provisions.

Borrowers should also consider the relationship between the time frame permitted for the exercise of equity cure rights and the Event of Default provision relating to the financial covenants. If a Default under the financial covenants occurs which is capable of cure (by means of equity cure or otherwise), a Borrower will want to ensure that it is able to remedy the Default before it becomes an Event of Default. An Event of Default has more serious consequences under the facility agreement than a Default and its existence is more likely to trigger cross default provisions or other negative consequences for the group. It is important therefore, from the Borrower’s perspective, that the applicable grace period for curing any breach of the financial covenants matches or exceeds the period within which any equity cure right can be exercised. It is also important the any agreed grace period does not begin to run until the Borrower becomes aware of the breach (ideally, no Default should occur until the date for delivery of the relevant compliance certificate, by which time, the extent of the group’s compliance with the financial covenants will be apparent).
Scope of deemed cure

If a breach of covenant is cured by means of additional equity, Borrowers should pay particular attention to the effects of the “cure”. Lenders often seek to provide that any recalculation of the financial covenants as a result of an equity cure is solely for the purposes of determining whether the relevant breach has been cured. If the recalculation indicates that the breach has been cured, it is common to see wording along the lines that any Default/Event of Default is deemed to be remedied from the date of the compliance certificate. The effect of such wording can be that the equity cure does not operate to negate all effects of a Default/Event of Default under the facility agreement and will need to be examined carefully by Borrowers.

By way of example, attainment of certain financial ratios during a period may entitle the Borrower to certain benefits under the agreement, such as a reduction in margin – it is common for margin ratchets to vary according to leverage targets. If a leverage target is achieved by means of the injection of additional equity, Borrowers may argue that the benefit of the margin reduction should apply (which is a stronger argument if equity cure amounts are applied to prepayment). If the effects of the equity cure are limited to curing any relevant Default/Event of Default under the financial covenants, this may not be the case.

Additionally, LMA-based documentation usually specifies that the negative effects of a Default/Event of Default subsist whilst that Default/Event of Default is “continuing”. A Default/Event of Default is usually defined as “continuing” until such time as it is waived and/or remedied. An equity cure operates to remedy a Default/Event of Default under the financial covenants and if the definition of “continuing” in the facility agreement provides that an Event of Default (for example) subsists until waived, the equity cure may not have the desired effect.

If an equity cure right is exercised, Borrowers will argue that any Default/Event of Default under the agreement should be cured for all purposes under the agreement and the agreement should operate as if the financial ratios had been complied with during the relevant period. If agreed, great care must be taken to ensure that the drafting is sufficient to achieve this result.

Impact of the credit crunch on equity cure rights

Market conditions remain uncertain, and as a result, Borrowers are having to work harder to achieve many of the concessions which would have been accepted as standard during the early part of this year. In relation to equity cure rights, we anticipate that in most circumstances, provided that they are coupled with fuller financial covenants, they should survive the crunch, having become a sufficiently established aspect of leveraged transactions. Borrowers and sponsors might, however, expect greater resistance from Lenders in terms of the operation of such rights. Requirements for equity cure amounts to be applied to repay debt, for example, may become more common, together with stricter limits on the number of times such rights are exercisable.