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“Oops, I Broke a Covenant”

In an earlier article, I wrote about how important having a “cash runway” is to a new company and that it is a favorite measure for lenders to use in gauging the ongoing financial health of a borrower. In fact, lenders may include a covenant, or contract term, related to a company’s cash runway in the credit agreement. Common covenants include ratios that a borrower must maintain, such as interest coverage, fixed charge coverage and debt service coverage ratios. All of these are referred to as “financial” covenants and are attempts for a lender to watch trends in a borrower’s financial condition and to predict, and hopefully ward off, potential repayment problems.

Financial covenants are at the crux of most credit agreements between borrower and lender. After the interest rate and payment terms, they are perhaps the most negotiated items of the agreement, and they allow lenders to monitor and grade borrowers after closing. Short of an actual payment default, a covenant default is likely the most serious issue a borrower will encounter with its lender post-closing. All borrowers must completely understand how the covenants are calculated and how they impact a lender’s thoughts and actions.

There will, doubtless, be “affirmative” and “negative” covenants in a credit agreement as well. These generally begin with the words “Borrower will…” and “Borrower will not…” and normally refer,

respectively, to actions the borrower must or must not take. They don't necessarily measure financial strength but require the borrower to do things, such as provide notification to the lender of certain events, remain in the same line of business, not to merge or sell assets without lender approval, and the like. While these are also very important, this article focuses just on financial covenants.

So, what happens in that unfortunate scenario when a borrower breaks a financial covenant? Well, let's be clear about this. The borrower is in default of the loan in virtually the same way it would be if it did not make a payment. The lender has many rights, including some drastic ones, that it may or may not choose to exercise. Every credit agreement reserves those rights so that a lender can postpone taking immediate action without losing its rights to take action later. Examples of actions available include instituting a default rate of interest, accelerating payment (i.e., demanding payment in full) and notifying guarantors or subordinated lenders (if any) of the default. Again, a lender will have those rights, and many more, at its disposal. But, in reality, not all covenants are weighted equally in a lender's mind. Every situation is unique. What a lender chooses to react to and how the lender responds are determined by many factors, not the least of which is how the borrower approaches the issue of covenant default.

Own the Issue – The Two Best Solutions

No matter the reason for the default, the best approach for a borrower is to "own" the default. You should explain how and what happened, but be careful not to cast blame. Lenders understand that "stuff happens," but it is not helpful to point fingers.

Focus on the situation and the cure. Ideally, a borrower should be proactive and be able to anticipate the default ahead of time. A communication to your lender that starts, "We are forecasting that we may breach the ABC covenant at the end of this quarter…" is the best way to approach what might otherwise be an unpleasant situation. This approach indicates you are paying attention to the "deal" you struck with your banker and have the ability to foresee issues. This will also give you and your banker time to address the issue without a sense of urgency. A covenant violation should effectively spur a productive conversation between borrower and lender to discuss that something, however minor, is different than was anticipated when the deal was closed. Perhaps the covenant needs to be altered or can be waived altogether for the quarter.

Any verbal agreement, waiver or amendment addressing the covenant default should be documented. This might be a simple letter or email from your banker or a modification to the credit agreement. Keeping a paper trail is always best practice and may be required by your

accountant or other interested stakeholders. Expect to pay some legal costs to amend the agreement or prepare a waiver. The lender will also likely charge a fee for the covenant breach. This may seem punitive, but it compensates the lender for its time and increased risk that was not originally contemplated in the deal.

The next best approach is to contact your lender immediately after realizing a covenant was broken. Borrowers are most likely to uncover covenant breaches while preparing their financial statements for the previous quarter. A phone call to your lender alerting it to the breach prior to sending in your financial statements should be your first priority. That call should include a thoughtful explanation and action plan, including new covenant compliance projections showing whether the default will continue or was a one-time occurrence.

Two Non-Solutions That Will Make Matters Worse...

There are two other scenarios that I have encountered regarding covenant defaults. Both are fraught with problems and are liable to cause serious, perhaps permanent, damage to a borrower/lender relationship.

The first is that the borrower is aware of the default but does not bring it to the attention of the lender, hoping that the banker either doesn't notice or doesn't care. Neither assumption is correct. If, or rather when,

the banker discovers it on his or her own, you can expect a rather abrupt phone call or a very legal-sounding email! Remember those "lender rights" mentioned earlier? You can be sure your banker does. The borrower will be in a position of severe weakness and will have forfeited any benefit of the doubt in this scenario.

The second scenario is that the borrower isn't aware of the default even after preparing its financial statements, despite the fact that a simple calculation or two would expose the issue.

These two scenarios are equally bad. The former shows a penchant to sweep an issue under the carpet (or worse, to mislead), and the latter shows a lack of attention to or understanding of your loan agreement.

My recommendation is to understand and address the issue, and propose solutions. Remember, being proactive is better than being reactive.

By Peter Hicks

Peter Hicks is a vice president and manages the Emerging Growth and Technology loan portfolio at Webster Bank. He works out of the bank's New Haven and Hartford offices. You can contact him at PHicks@websterbank.com.