August 22, 2014

Equity Cure Rights in Loan Agreements

Introduction

The purpose of each of our client memos is to highlight for the reader developments in the middle-market lending space that we have observed over the course of our practice. While each deal is different, over time certain identifiable trends arise and may even become fixtures of loan documentation.

This client memo will outline the basic concepts and mechanics of a loan provision commonly known as an equity cure right and will seek to describe the qualifications and limitations lenders have required in order to incorporate this provision into their loan agreements.

Overview

Equity cure rights give the borrower (specifically the borrower's financial sponsor) the right, but not the obligation, to increase its calculated EBITDA through an equity contribution. This right becomes relevant when the borrower has failed to satisfy one or more of its EBITDA-based financial covenants.

The equity cure right has gained significant acceptance in all ranges of the middle market for sponsor backed deals. It is a loan provision that is consistently requested by knowledgeable sponsors and one that lenders have grown comfortable including in their loan documents with appropriate lender safeguards.

For a sponsor, the equity cure right provides a way to avoid a default and evaluate its options to address an underperforming portfolio company. Additionally, a cure right allows the sponsor to avoid: (i) the time and expense of seeking a default waiver or forbearance, (ii) paying waiver and amendment fees to the lender and (iii) being forced back to the table to renegotiate the basic terms, conditions and economics of its existing loan agreement.

Financial Covenant Defaults

A financial covenant, unlike an affirmative or negative covenant, is not an agreement by the borrower to take or refrain from taking certain actions; it is the measurement of a borrower's financial performance, and akin to a tripwire, a warning to the bank of a deteriorating credit. Once triggered, the covenant breach permits the bank to accelerate the loan and, as a practical matter, gives the bank leverage to force the borrower back to the table to renegotiate the economic terms of the loan.

Unlike a standard covenant, a financial covenant breach is traditionally not capable of being cured given that it is based on historical financial performance.

The equity cure right creates a mechanism by which a sponsored borrower can increase historical EBITDA in an amount sufficient to satisfy its financial covenants.

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Equity Cure Right Structure

While there are any number of financial covenants appearing in loan agreements, the two most common, and those that we will consider in this memo, are the leverage ratio and the fixed charge coverage ratio.

Both the leverage ratio and the fixed charge coverage ratio are calculated using EBITDA and it is the EBITDA number that is increased by an equity cure. Certain credit agreements implement equity cures through debt reduction (rather than EBITDA increases), but this approach is far less common.

Upon the occurrence of a financial covenant default, an equity cure provision allows the borrower's sponsor to make an equity contribution to the borrower within some set period of time after delivery of the financial statements reporting the covenant failure. The dates for an equity cure notice to be delivered and for the required contribution to be made vary across different agreements; however, a common timeline is that the sponsor must make the required contribution within 10 business days after the financial statements reporting the covenant failure have been delivered.

An event of default is deemed to exist for all purposes of the loan document during the time period between a cure notice being delivered to the lender and the required contribution being made; however, the lender agrees to forbear from exercising remedies or applying any default interest rate during this period.

Mechanically, the equity contribution will take one of two forms: (i) the issuance of preferred equity with a maturity at least 180 days after the maturity of the credit facility or (ii) a capital contribution based on existing equity held by the sponsor.

In the ordinary course of business, an equity contribution would not bolster revenue of the borrower and would have no impact on EBITDA. An equity contribution would traditionally be categorized as additional paid-in-capital and would only increase the owner's equity on the balance sheet, having no impact on the income statement.

The equity cure mechanism in a loan agreement permits the borrower to use such paid-in-capital to increase EBITDA on a dollar-for-dollar basis, allowing the borrower to "turn back the clock" and upwardly revise its financial results. As a result, a seemingly incurable covenant breach can now be cured. The equity cure provision provides that upon the exercise by a sponsor of its cure rights and the completion of the equity contribution, the borrower is deemed to have been in compliance with the applicable covenant ratios as of the measurement date.

Restrictions and Limitations on Equity Cures

Like most negotiated provisions in a loan agreement, there are certain restrictions that limit a sponsor's rights to make such cures.

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Limits on Use of Proceeds
The cash proceeds of an equity cure must often be used to prepay the credit facility (with a corresponding permanent reduction in the commitment amount).

While the prepayment of indebtedness is not the favored mechanism for effecting the equity cure, it is common in middle-market credit agreements for the lender to require that after the proceeds of the equity contribution have been applied to the EBITDA calculation to cure the covenant default, the borrower must prepay the indebtedness in the amount of such proceeds.

Limits on Amount
The sponsor can only contribute the amount necessary to cure the covenant breach. Furthermore, the equity cure amount may be limited by an overall percentage of EBITDA. A common cap is 15 percent of EBITDA.

Limits of Frequency
The most common tool that lenders have to control the equity cure right are limits on how often the cure right can be used. There are usually two separate limits: (i) a limit on the number of times that the cure right can be used during any consecutive four quarters, and (ii) a limit on the number of times that the cure right can be used during the term of the credit agreement. For middle-market transactions, a limit of two uses in any four consecutive quarters and three to four uses total for the entire term of the credit agreement would be typical.

Limits on Impact of Increased EBITDA

- In certain instances, the contributed amount applies only to EBITDA on a pro-forma basis as of the applicable measurement date and is not permitted to be included in the calculation of EBITDA for any future measurement periods. This is a negotiated point and borrowers or equity sponsors with more negotiating leverage oftentimes get lenders to agree that the proceeds will be included in the calculation of EBITDA for each quarter in which the applicable measurement date is part of the measurement period.

- EBITDA is deemed to be increased only for the purposes of calculating the specified financial covenant ratios for compliance purposes and not for any other purpose, which is particularly important in the event that the loan agreement includes a pricing grid or other EBITDA-based mechanism for determining interest rates, prepayment percentages, grower baskets based on cash flow or pro-forma covenant compliance used to determine whether or not an action that is conditioned upon such pro-forma compliance may be taken by the borrower.

Limits on Impact of Prepayment
If the borrower is required to prepay the indebtedness in the amount of the proceeds, it is important for the lender to include language that specifies that any prepayment of the indebtedness is not applied retroactively and does not lower the amount of the indebtedness as of the applicable measurement period for which the equity cure is being exercised. If the credit agreement does not include this language, it creates the potential for double dipping, where the borrower tries to apply the proceeds to

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reduce the indebtedness while also increasing the EBITDA for the specified measurement date, the result being a lower required equity contribution.

Conclusion

Like a number of middle-market loan innovations, the equity cure was developed in the "Big Sponsor" market and has migrated down to almost all levels of the middle market.

That said, as middle-market lenders adapt equity cure provisions from large cap transactions, they are reflecting the middle-market risk profile by including tighter controls on the use of the proceeds and limits on the borrower's ability to exercise the cure right.

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This document is intended to provide you with general information regarding equity cure rights in loan agreements. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorneys listed or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

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