UNBEARABLE LITE-NESS: LENDERS' REMEDIES IN THE AGE OF MISSING COVENANTS

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The last decade has seen a significant shift in the leveraged loan market, including here in Canada. Loosening monetary policy, fierce competition among lenders and the return of securitized corporate debt products over the past several years have driven a trend of deteriorating lender protections in loan documents.[1] This includes the much discussed trend towards 'covenant-lite'[2] loans. While not as prevalent as in the United States, covenant-lite and related trends have penetrated the Canadian market.[3] This is especially so in connection with Canadian targets of leveraged M&A deals with US-based sponsors and lenders.

With the COVID-19 pandemic serving as a catalyst, global markets have taken a dramatic turn for the worst in recent weeks.[4] Stakeholders across the financial services industry are checking in on the health of their loans and security packages. They are wise to take note of the remedies that might (or might not) be available to lenders in Canada. As liquidity markets tighten and borrowers attempt to draw down on existing loan facilities, lenders want to know what remedies they have to prevent the erosion of their collateral. Recent high-profile litigation in the United States brings into stark relief some of the risks that accompany the trend towards debtor-friendly loan documents.

This bulletin explores some of the characteristics of debtor-friendly loans, the risks they pose to lenders, and the landscape of lenders' remedies in Canada. This topic will be of special interest to participants in the leveraged loan market as well as private equity funds, both as sponsors of Canadian portfolio companies and potential distressed investors.

The shift towards a debtor-friendly market for leveraged loans

Prior to the 2008 financial crisis, the global market for leveraged loans was far more bank-centric and covenant-heavy than it is today.[5] The years since have seen a meteoric rise in nonbank leveraged lending, with leverage rates returning to pre-crisis levels. In 2018, the market for leveraged loans reached well over USD $1 trillion. Many observers agree that the phenomenon has been driven by a fiercely competitive lending market during the last decade. Covenant-lite loans have proliferated in the middle market, largely originating with nonbank lenders (sometime called the 'shadow banking' system). A salient feature of the leveraged loan market has been the sale of the corporate debt through collateralized loan obligations (representing over half of the ownership of covenant-lite debt), which are often bought by loan funds, insurance companies, mutual funds, and ETFs that are hungry for yield.[6]

The shift towards less lender control over debtors through stringent loan requirements has its defenders. Without burdensome covenants to trip over, debtors are less likely to default when their businesses face periods of distress. More autonomy allows debtors to run their businesses as they think best in order to navigate financial difficulties without being subordinated to the narrow goal of creditor recoveries.[7] Regardless of such virtues, many observers predict that the trend toward weaker lender protections will lead to significantly lower recoveries in the next restructuring cycle.[8] Some aspects of the trend are discussed below.

Covenant-lite and related trends

'Covenant-lite' usually refers to the absence of a 'maintenance test' in credit agreements. Maintenance tests require debtors to satisfy certain financial metrics (including leverage ratios, interest coverage and capital expenditures) on an ongoing basis to ensure their businesses remain in good financial health. These requirements are satisfied through regular testing, usually quarterly. They offer lenders powerful protection as they provide an early warning sign of distress and a tool to force the debtor to negotiate before collateral is squandered. The covenant-lite trend marks a departure from maintenance tests in favour of 'incurrence tests' in loan agreements, which have been historically associated with bond indentures rather than loan agreements. Incurrence tests are only triggered when the borrower wishes to conduct certain major transactions (incur additional debt, pay a dividend, etc.) - they don't require ongoing monitoring of a business' financial health.

Another significant trend has been increasingly *loose definitions of 'EBITDA'* (earnings before interest, taxes, depreciation and amortization - the principal measure of a company's revenue) in loan documents. These definitions inform a variety of rights and obligations of the borrower. Generous EBITDA definitions might inflate the business' apparent revenue and artificially decrease its leverage ratio. They can also expand debtors' ability to take steps permitted in their loan agreements that place collateral at risk, including greater incremental borrowing or using exceptions to restrictions on asset sales. Some definitions of EBITDA are so flexible that major ratings agencies do not make reference to them when rating a company's debt.

Flexible incremental loan baskets have also become common. The absence of a maintenance test and a generous EBITDA definition permit debtors to borrow more than they otherwise would beyond the lender's loan facility (incremental borrowing). Some loan documents also have weak restrictions on the pricing of new loans, permitting higher cost loans from new lenders without any compensation to the existing lender for the increased risk resulting from higher debt service obligations.

Finally, permissive exception 'baskets' in negative covenants have allowed some borrowers to alienate large portions of lenders' collateral package. Such exceptions have led to high-profile litigation in the United States in connection with household company names, including a dispute over the now notorious 'J. Crew Trapdoor'.

Remedy-lite?

Cases in the United States in the past few years shed light on the risks posed to lenders by debtor-friendly loan documents. While Canadian corporate law ostensibly offers strong protections to creditors, courts here have sometimes been unforgiving to lenders that seek relief outside the four corners of their loan documents.

Two high-profile cases in the United States involved aggressive use by borrowers of the exception baskets in their negative covenants to move valuable assets outside of their lenders' collateral packages. In 2016, the well known private equity-backed retailer J. Crew transferred the majority of its intellectual property (an especially valuable part of its assets) to unrestricted affiliates in a series of transfers that purported to take advantage of two separate baskets in its negative covenants.[9] The assets were then used to secure a refinancing of junior debt. This use of basket combinations to move assets outside of a lender's collateral package has come to be known colloquially as the 'J. Crew trap door'.[10] The pet retail chain PetSmart conducted a similar asset transfer in 2017.[11] It moved 35% of the shares in its 'Chewy' subsidiary (an online sales platform) to unrestricted affiliates through a complex series of transactions that purported to exploit the permitted investment baskets in its negative covenants. This would result in the release of Chewy's guarantees of PetSmart's debt and free up its collateral for new financing.[12] Neither the J. Crew nor PetSmart cases resulted in a court decision.

Another US case, *Quadrant Structured Products Company, Ltd. v. Vertin,*[13] did result in a decision of the Delaware Court of Chancery. It involved two competing distressed asset investors pursuing interests in an insolvent securities trading company. One investor bought all of the company's equity, perceiving that its covenant-lite loan documents and distant maturity dates would permit the company to shift investment strategies, equitize junior debt and pay a large dividend. It appointed insiders to the company's board. Meanwhile, a second investor bought some of the company's debt in the belief that the company's notes were undervalued given the underlying collateral and that the company would be obligated to liquidate its assets. Litigation ensued. The company completed a plan that maximized value for equity, despite their being sufficient assets to provide a meaningful recovery by creditors. The debt investor alleged that the company's board preferentially transferred value to the equity investor. It alleged that the board breached its fiduciary duty and caused the company to breach the express terms of its trust indenture or the *implied term of good faith*. The Court rejected the claims. Regarding good faith, the Court held that certainty of the indenture's terms is paramount. It observed that the debt investor was "seeking to obtain a right that it did not bargain for explicitly".[14] However, the Court left open the possibility that the good faith doctrine might be brought to bear on creditors' rights in other circumstances.

A variety of remedies are ostensibly available to creditors in Canada but courts have been reluctant to use them to assist lenders who can't find adequate protections in their loan documents. The Supreme Court of Canada has described the *oppression remedy* that is codified in various Canadian corporate statutes as granting "the broadest rights to creditors of any common law jurisdiction".[15] However, Canadian court decisions have not always been friendly to lenders.[16]

To succeed on an oppression remedy application, a claimant must show that they had a 'reasonable expectation' that has been oppressed or unfairly prejudiced or disregarded.[17] Factors that courts will examine to determined reasonable expectations include the parties' agreements and steps the claimant could have taken to protect itself.[18] In *Re BCE*, the Supreme Court of Canada rejected the claims of a company's bondholders to have reasonably expected the company to maintain their debentures' trading value in the face of a proposed leverage buyout. The Court noted that a leveraged buyout was not "unforeseeable" and the parties' trust indenture could have given bondholders the protections they wanted, but it did not.[19] An Ontario Court reached a similar conclusion in *Computershare Trust Co. v. Crystallex International Corp.*[20] It rejected an oppression claim by bondholders where their trust indenture did not contain certain protections for noteholders that could have been negotiated. The decision also noted the high yield on the bonds, which reflected the risk that the bondholders assumed. The decision was upheld by the Ontario Court of Appeal, which agreed with the application judge "that it is not for the court to read into the [loan] documentation terms that would enhance the protection afforded to the [lenders] by the agreed to terms."[21]

Another remedy theoretically available to lenders is a statutory duty of care owed by the debtor corporation's directors.[22] However, this duty can be satisfied where the directors show that their actions were reasonable from the perspective of the interests of the company. This is so even where the reasonable actions are predictably detrimental to the interests of the lender.[23] Canadian common law also recognizes a duty of good faith as a 'general organizing principle' in the law of contracts, as well as a specific duty of good faith performance of contracts.[24] However, this area of contract law is notoriously amorphous an unclear (it will be revisited by the Supreme Court of Canada in 2020). To date, it has not proved much assistance to lenders. In one case, the British Columbia Supreme Court held that the leading authority on good faith "did not alter the principles for contract interpretation nor did it permit the reading in of terms into [the parties' credit agreement] of obligations that do not exist".[25]

Finally, the fiduciary duty of directors of Canadian corporations does not offer much assistance to frustrated lenders either. In other jurisdictions, that duty can be an arrow in a lender's quiver under the theory that the fiduciary duty shifts towards the interests of creditors when the company is 'in the vicinity of insolvency'. The Supreme Court of Canada has definitively rejected that proposition in Canada. The duty is always owed to the corporation rather than to any particular group of stakeholders.[26]

Takeaways

The J. Crew trap door and similar vulnerabilities to collateral exist in many loan documents. As debtors are hit with the dual shock of plummeting revenues and tightening credit markets, they may attempt significant asset transfers to secure additional financing. Lenders may also be frustrated by drawdowns on existing facilities and the various business strategies that debtors adopt to cope with the downturn. All parties should turn their minds now to the strengths and weaknesses in their financing arrangements.

- **Revisit your loan documents:** Both borrowers and lenders should revisit their loan documents now. Borrowers should understand what their existing covenants permit and prohibit as they developed strategies for coping with a downturn. Lenders should take note of any vulnerabilities to their collateral and other weaknesses, and consider how they might be addressed. They may have an opportunity to negotiate better loan protections before it's too late. Lenders may have leverage if the borrower fails to comply with certain less material covenants (like notice or reporting requirements) or wishes to make a further draw on their facility (which sometimes has preconditions, including that initial representations and warranties about the business' financial health remain true). '*Material Adverse Change*' or '*Material Adverse Effect*' clauses might also provide some leverage in negotiations, depending on their language. One proactive step that lenders may wish to explore is the offer of new money (particularly needed in the current climate) as a means of initiating negotiations to tighten key covenants. Lenders should first take stock of the sticks and carrots they have, then use them proactively in negotiating better protections.[27]
- **Ask what litigation might look like:** Check which jurisdiction's laws govern the loan documents. In Canada, lenders' remedies will be primarily grounded in the text of their agreements. Under Canadian common law, agreements are interpreted with reference to their surrounding 'factual matrix'. In cases involving complex financial instruments, litigation might involve evidence (sometimes from experts) about the nature and details of sophisticated lending arrangements as well as market practice. Where litigation seems likely, both lenders and debtors should take early and careful note of both the words in their agreements and how they fit into the surrounding transaction, and discuss them with experienced counsel.
- **Consider the lender's reasonable expectations:** Both parties should consider what the lender's reasonable expectations are and what evidence exists to support them. Apart from the parties' loan documents, look at representations that the debtor has made about how it will conduct its business or deal with its assets (including in public disclosure documents), past practice and prevailing market norms. Despite recent case law, a wave of distress to highly leveraged debtors with flexible loan documents may force courts to revisit some central aspects of Canadian corporate law, including the oppression remedy. Lenders should start to document their expectations now if they haven't already.

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[1] For good explanations of these trends and related statistics, see: Bain Capital Credit: *Credit Market Insights Q2 2019*; S&P Global Ratings (Global Leveraged Finance, June 2019), *When The Cycle Turns: Assessing How Weak Loan Terms Threaten Recoveries;* Reuters, "Leveraged loan market size double in ten years, private credit explodes" (December 23, 2019); Bloomberg, "Fate of Leveraged Loans Won't Be Decided by Cov-Lite Alone" (February 20, 2019).[ps2id id='1' target="/]
[2] The term 'covenant-lite' or 'cov-lite' describes loan agreements with weak or no maintenance test (described further in this bulletin), but is sometimes used as a shorthand for a broader trend towards debtor-friendly loan documents.[ps2id id='2' target="/]
[3] 'Much of the growth in these loans in Canada has been funded by the US leverage loan market. See Bank of Canada, *Financial System Review, 2019*. See also "'Covenant creep' is making high-yield debt riskier for investors", *Financial Post*, April 3, 2019.[ps2id id='3' target="/]
[4] The risks present in the leveraged loan market were being discussed well before the appearance of the coronavirus. In May 2019, U.S. Fed Chairman Jerome Powell noted that a sudden economic downturn could place severe strain on overly indebted businesses and their non-bank private lenders. See also "'This will end poorly', says J.P. Morgan strategist about a boom in arcane debt on Wall Street", MarketWatch, March 7, 2019:[ps2id id='4' target="/]
[5] Bain Capital Credit: *Credit Market Insights* Q2 2019.[ps2id id='5' target="/]
[6] See Bloomberg, "Powell Says Leveraged Lending Isn't Posing a Crash Threat" (May 20, 2019).[ps2id id='6' target="/]
[7] See "The case for covenant-lite" (March 26, 2018).[ps2id id='7' target="/]
[8] S&P Global Ratings (Global Leveraged Finance, June 2019), *When The Cycle Turns: Assessing How Weak Loan Terms Threaten Recoveries*.[ps2id id='8' target="/]
[9] See plaintiffs' claim: *Eaton Vance Management et. al. v. J. Crew International Inc. et. al.,* index number 654397/2017.[ps2id id='9' target="/]
[10] Bloomberg, "In Finance, 'J. Crew' Is a Verb. It Means to Stick It to a Lender" (June 17, 2019).[ps2id id='10' target="/]
[11] S&P Global Ratings, "The PetSmart Case: A Deep Dive Into Its Equity Transfer Of Chewy Inc." (November 8, 2018). See PetSmarts claim against administrative agent: *Argos Holdings Inc. and PetSmart Inc. v. Citibank, N.A.*, Case No. 18-cv-5773 in the United States District Court for the Southern District of New York.[ps2id id='11' target="/]
[12] Both the J. Crew and PetSmart cases proceeded to litigation but did not result in any court decisions that might have provided guidance on the brazen exploitation of weak loan documents by debtors.[ps2id id='12' target="/]

[13] 2015 WL 6157759, C.A. No. 6990-VCL (decision dated October 20, 2015) [*Quadrant*].[ps2id id='13' target=''/]
[14] *Quadrant*, page 14.[ps2id id='14' target=''/]
[15] *People's Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68 [People's], at 48.[ps2id id='15' target=''/]
[16] Notwithstanding the *BCE and Crystallex decisions, lenders have brought some successful oppression applications. See Deutsche Bank Canada v. Oxford Properties Group Inc.,* [1998] 40 B.L.R. (2d) 302, *Highfields Capital I LP v. Telesystem International Wireless Inc., [2002] O.J. No. 384, Royal Bank v. Amatilla Holdings Ltd., 1994 CarswellOnt 2680, Sidaplex-Plastic Suppliers Inc v Elta Group Inc.*, (1995), 25 BLR (2d) 179 (Ont Gen. Div). ONSC 6805.[ps2id id='16' target=''/]
[17] For an example of the statutory oppression remedy, see *Canada Business Corporations Act,* R.S.C. 1985, c. C-44, Section 241.[ps2id id='17' target=''/]
[18] *Re BCE,* 2008 SCC 69 [BCE] at 56.[ps2id id='18' target=''/]
[19] *BCE* at 108.[ps2id id='19' target=''/]
[20] [2009] OJ No 5435 [Crystallex].[ps2id id='20' target=''/]
[21] Computershare Trust Co. of Canada v. Crystallex International Corp., 2010 ONCA 364 at 14.[ps2id id='21' target=''/]
[22] See for example *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, Section 122(1).[ps2id id='22' target=''/]
[23] See *Peoples* at 66-71.[ps2id id='23' target=''/]
[24] *Bhasin v. Hrynew*, 2014 SCC 71.[ps2id id='24' target=''/]
[25] *Maxam Opportunities Fund Limited Partnership v. 729171 Alberta Inc.*, 2015 BCSC 271 at 168.[ps2id id='25' target=''/]
[26] *Peoples* at 43, 46.[ps2id id='26' target=''/]
[27] However, lenders should be aware of restrictions on insider trading under applicable securities laws, especially where they might receive material non-public information about an issuer in the course of negotiations.[ps2id id='27' target=''/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.