PRACTICE NOTE

Covenant-Lite Loans: Overview

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This Note explains the typical features of covenant-lite loans and examines the benefits and drawbacks of covenant-lite loans for borrowers and lenders.

A covenant-lite (or cov-lite) loan is a borrower-friendly type of loan facility found in certain leveraged financings. In the past, cov-lite loans were most likely to be found in syndicated loan transactions, however, during the last several years, cov-lite loans have become commonplace in private, direct lending deals as well.

The core feature of any cov-lite loan is the absence of financial maintenance tests requiring the borrower to meet certain performance criteria monthly or quarterly (see Box, Purpose of Financial Covenants). A cov-lite loan also typically has a covenant package with features similar to high-yield bonds, including incurrence-style negative covenants. However, cov-lite loans can come in many different variations having some or all of the features discussed in this Note (see Cov-Lite Loan Provisions).

Cov-lite loans have been a well-established feature in the leveraged lending marketplace for many years. Although January 2022 was the second-busiest January on record for leveraged loans as the war in Ukraine and higher inflation, increasing interest rates and other macroeconomic trends persisted, the leveraged lending market faced significant challenges in the last three quarters of 2022 and during most of 2023. The US leveraged lending market picked up in the first half of 2024, and, it surged in the fourth quarter of 2024 after interest rates were lowered three times. According to PitchBook|LCD, there was a record $1.4 trillion of activity in the new-issue lending market. Omitting repricings to reduce the spread and maturity date extensions, new issue loan volume was $501 billion, which is double the volumes in 2022 and 2023 and was just short of the 2017 volume. Investor demand for loans reached a three-year high. However, M&A activity remained low. In 2024, syndicated loans to finance LBOs, sponsor add-ons and corporate M&A fell from $46 billion market in the third quarter of 2024 to $28 billion in the fourth quarter. Although this was an increase from 2022 and 2023, it was still below the 10-year quarterly average.

The Federal Reserve reduced interest rates three times in late 2024, fueling a repricing wave in the fourth quarter of 2024. There was a record number of repricings totaling $757 billion, largely exceeding the prior record in 2017 of $432 billion. Borrowers continued to focus on managing their debt maturity walls and closed many amend & extend transactions. The leveraged loan market ended 2024 with the second busiest quarter ever. Private credit continued its exponential growth, although in 2024, the syndicated market regained some of the momentum it had lost to private credit in 2023.

The trend toward cov-lite loans remained steady in 2024. At year-end 2024, the volume of cov-lite loans outstanding in the US reached approximately $1,292.74 billion, and cov-lite loans represented approximately 91.09% of the outstanding US leveraged loans (at par), according to PitchBook|LCD, an increase of approximately 1.86% over 2023. At year-end 2023, the volume of cov-lite loans outstanding in the US reached approximately $1,248.87 billion, and cov-lite loans represented approximately 89.23% of the outstanding US leveraged loans (at par), according to PitchBook|LCD. At year-end 2022, the volume of cov-lite loans outstanding in the US reached approximately $1.259 billion with cov-lite loans representing approximately 88.91% of the outstanding US leveraged loans (at par) according to PitchBook|LCD.

Cov-lite loans represented approximately 93% of the total volume of all US institutional leveraged loans issued in 2024 while they represented 93% of the total volume of US institutional leveraged loans issued in 2023.

This Note explains the:

- Typical provisions of cov-lite loans.
- Elements of cov-lite loans.
- Pros and cons of cov-lite loans for borrowers and lenders.

For links to cov-lite credit agreements, see Practice Note, What's Market: Covenant-Lite Loans.

Cov-Lite Loan Provisions

Although every cov-lite loan transaction is different, there are some common patterns and themes in the structures. Cov-lite features are most commonly found in cash flow financings, but they also appear in certain asset-based lending (ABL) transactions. Borrowers saw a scaling back of borrower-friendly documentation terms in late 2022 and continuing in 2023 due to market volatility resulting from rising interest rates, higher inflation, the war in Ukraine, decreased M&A activity and other macroeconomic trends. Cov-lite loans dominated the leveraged loan market in 2024, and increasing competition in the private lending market has resulted in some lenders removing covenants in deals for entities with EBITDA as low as $30 million rather than the traditional minimum EBITDA of $50 million.

The trend towards increasing cov-lite loans may explain, in part, the explosive growth in direct lending (private credit) loans which historically contained some covenant protection for lenders, although, recently direct lending loans have moved towards cov-lite, "cov-wide" or "cov-loose" terms. Recently, direct lenders have extended more cov-lite loans to middle market borrowers. Direct lenders, including hedge funds and private equity firms, are non-bank lenders extending loans historically to small and medium enterprises, though beginning in 2021, direct lenders became more active in larger, multi-billion dollar financings. In the direct lending market, the unitranche loan has become a popular structure. In 2023, a number of broadly syndicated loans were refinanced by private credit financings but, according to S&P Global Ratings, this trend stagnated or reversed a bit in 2024 as borrowers took advantage of improved conditions in the broadly syndicated market.

Cash Flow Deals

A typical cov-lite cash flow loan has the following structure:

- One loan agreement that includes both a funded term loan or series of term loans and, possibly, a relatively smaller revolving credit facility. If there is not a revolving credit facility, a separate ABL may be used in cash flow financings.
- All of the credit facilities share the same covenants (other than, if there is a revolving facility, financial maintenance covenants or "springing" financial maintenance covenants), mandatory prepayments and events of default.
- All of the credit facilities are secured by the same collateral, which the facilities share ratably although some more recent deals have a priority first-out revolver.

Generally, these deals either have no financial maintenance covenants or financial maintenance covenants that only apply to any included revolving credit facility (see Box, Purpose of Financial Covenants). In the latter case, remedies upon a breach of the financial maintenance covenants (usually a single covenant, such as a maximum leverage ratio) will be within the control of the revolving credit lenders only. The revolving credit lenders (usually by majority vote of the class), to the exclusion of the term loan lenders, will have the power to:

- Amend or waive the terms of the financial covenants.
- Declare an event of default relating to a breach of the financial covenants.
- Direct the exercise of remedies resulting from an acceleration based on breach of the financial covenants.

In certain transactions, if the revolving credit lenders do not agree to a waiver of the breach within a specified time period (usually between 45 and 90 days) the term loan lenders may declare a default and begin exercising their remedies for the breach of the financial maintenance covenant. Often the term loan lenders may declare a default only if the revolving credit lenders accelerate their loans.

It is also typical in these cov-lite loan transactions with included revolvers for the financial maintenance covenants to be "springing" in nature, meaning they will only apply to the revolving credit facility if certain thresholds are met. For example, the threshold can be that any revolving credit loans are outstanding or the revolving credit outstandings are above a certain dollar amount or percentage of the total revolving commitments (35% to 40% or higher is common). A borrower may also be able to negotiate a basket for issuing a certain amount of letters of credit before the covenant applies. As a result, the borrower can avoid being required to meet any financial maintenance covenant if, at the time the covenant would otherwise be measured, it reduces its revolving credit usage below the threshold trigger. For this reason, among others, lenders may in some transactions require the financial covenant to be satisfied on a pro forma basis as a condition to making new revolving credit loans or issuing or extending letters of credit. Some borrowers continue to negotiate successfully to exclude undrawn letters of credit from the leverage calculation. In some cases, cash and cash equivalents are deducted from the amount of drawn revolving credit commitments at the testing date.

In contrast, in deals with full financial maintenance covenants, breach of one of these covenants is normally an immediate event of default regardless of the amounts outstanding at the time. If an event of default occurs, the Agent or all of the lenders (term and revolving lenders voting as a single class) by majority vote can exercise available rights and remedies.

Asset-Based Lending

Cov-lite loans can also be structured using an ABL for the revolving credit portion. Typically, this involves an ABL revolving credit facility with a separate cash flow term loan (or multiple term loans).

In these transactions, the ABL revolving credit facility is documented separately from the term loan, and will have a different covenant package and prepayment events. The ability of the borrower to use the ABL facility is limited by a borrowing base formula often tied to a percentage of accounts receivable and a percentage of inventory meeting certain eligibility criteria in the ABL documents which generally have a springing financial maintenance covenant for minimum fixed charge coverage. Unlike a cash flow cov-lite loan transaction where springing covenants are tied to the usage of the revolving credit facility, the trigger in an ABL cov-lite transaction is, typically, tied to the amount of remaining availability under the borrowing base formula.

In an ABL cov-lite transaction, the term loan is documented in a separate agreement that would not have any financial maintenance covenants. To prevent the term loan lenders from getting the benefit of the ABL financial maintenance covenant, the term loan agreement usually has a cross-acceleration to the ABL facility rather than a cross-default. This means the occurrence of an event of default in the ABL facility will not trigger an event of default under the term loan facility unless and until the ABL lenders have accelerated their debt.

For more information on ABL transactions, see Practice Note, Asset-Based Lending: Overview.

Direct Lending (Private Credit)

Direct lending transactions are leveraged loans made by entities other than traditional banks, such as hedge funds, private equity firms, insurance companies, and business development companies. This class of debt has increased dramatically over the last few years, almost tripling in size over the last decade according to Bloomberg. Direct lenders are not constrained by the capital requirement regulations that limit banks from lending to more highly leveraged borrowers. Historically, banks became concerned about lending to smaller and mid-market companies, and direct lenders were willing to fill that gap. Recently, larger companies have turned to direct lenders for loans as well. Competition for deals has forced lenders to accept looser documentation terms, and direct lenders now provide cov-lite loans on a competitive basis with syndicated lenders. According to PitchBook|LCD, direct lenders traditionally limited the category of borrowers able to obtain debt on a cov-lite basis to those with at least $50 million in EBITDA, but as the market has become more competitive, private lenders have increasingly executed transactions on a cov-lite basis for some entities generating as little as $30 million in EBITDA. In some cases, loans may contain covenants, but they are so generous that it would be unlikely they would be triggered unless the borrower incurred a rapid and significant decline in its financial performance. These loans are known as “covenant-loose” or “covenant-wide” loans. More recently, direct lenders are accepting competitive terms including PIK interest and also moving into the asset-based lending arena. In 2023, direct lenders refinanced broadly syndicated debt in several deals, though that trend did not hold up in 2024 as conditions improved in the syndicated market.

Unitranche loans are a popular structure used in the direct lending market. Unitranche debt is a hybrid loan that combines senior and subordinated debt into one debt instrument under which the borrower pays a blended interest rate that falls between the rate of the senior debt and the subordinated debt. If the loan is provided by more than one lender, the intercreditor arrangements are addressed in a separate agreement among the lenders. Direct lenders are the primary providers of unitranche debt. Unitranche lenders frequently seek non-call protection for the first 12-24 months after closing, and generally hold the loans long-term or until maturity. Unitranche loans usually have little or no amortization with a bullet payment at maturity. Borrowers benefit from unitranche loans due to their simplicity, speed of execution, reporting requirements, certainty of closing, privacy, ability to deal with a single lender (or a small group of lenders), and ability to negotiate flexible covenants and other terms. In addition, small and mid-size borrowers gain access to financing that traditional banks may not offer to more risky companies. Lenders receive warrants or equity co-investment rights in connection with some unitranche transactions.

Unitranche debt volume has increased dramatically. According to PitchBook|LCD, based solely on transactions reported by PitchBook|LCD, unitranche loans totaled approximately $17.61 billion, 28.34 billion and $18.51 billion in 2022, 2023 and 2024, respectively. In September 2023, direct lenders provided a roughly $4.8 billion unitranche loan in connection with the $5.3 refinancing package extended to Finastra Group Holdings Ltd., the largest takeout of an institutional loan by private credit lenders. Hyland Software Inc. also refinanced institutional debt with a $3.4 billion cov-lite unitranche loan provided by direct lenders in 2023. In December 2023, a direct lender group structured a $1.7 billion cov-lite unitranche loan for the software firm Aptean Inc. NextGen Healthcare obtained a $1 billion unitranche loan in December 2023 in connection with a take-private deal by Thoma Bravo. Enverus closed on a $2.3 billion unitranche facility in January 2024 arranged by Golub Capital. In June 2024, National Carwash Solutions, a portfolio company of Berkshire Partners, received more than $1 billion in unitranche financing led by Oak Hill Advisors. Direct lenders expect to continue to compete with traditional banks, though as market headwinds have shifted and M&A activity has slowed, unitranche deal sizes have decreased from prior highs. In 2024, unitranche activity dipped given the strength in the broadly syndicated market. Direct lenders are able to customize loans and structures and have shown flexibility by including a portability feature in some loans.

As volatility continued in the leveraged lending market in 2022 and 2023, borrowers, including private equity funds and their portfolio company borrowers, were seeking additional ways to obtain funds for working capital and acquisitions while complying with their existing debt documents. Direct lenders were ready and willing to fill the gap left by traditional lenders during those years by providing incremental debt or ratio debt (each described further below). Borrowers and direct lender(s) evaluate whether the new debt will be slotted in as incremental debt under an existing loan agreement (an accordion) and if so, whether it will be an identical tranche or have different economic and/or other terms or whether the new debt will be incurred under a separate debt agreement (incremental in-lieu aka incremental equivalent debt) and if so, how the terms will vary from the original loan. Additionally, borrowers may have capacity to incur debt from direct lenders under two negative covenant baskets, the “ratio-debt” and “acquisition debt” baskets. These two baskets may provide fewer protections to existing lenders than incremental debt or incremental in-lieu debt provisions contain. When direct lenders consider lending into an existing structure, they may request some amendments to entrench their interests and to limit dilution. Syndicated credit agreements usually provide the borrower and a new lender some latitude to make lender-favorable changes subject to the MFN provisions (as described below) and other protections.

Liability Management Transactions

Liability management transactions (LMTs), in which borrowers seek to “manage” their balance sheets by restructuring their debt, have become an increasingly utilized strategy in the leveraged finance markets beginning in 2016 with the JCrew drop-down financing. In 2024, when there was a large amount of capital to be deployed and higher interest rates put pressure on borrowers’ balance sheets, borrowers effected a record number of LMTs. LMTs have also become a strategy for borrowers emerging from bankruptcy.

LMTs can take various forms, such as:

- A “dropdown,” when borrowers transfer assets, such as intellectual property or other specified assets, to unrestricted subsidiaries or non-guarantor restricted subsidiaries and then incur debt secured by those assets which is structurally senior to the existing debt.

- An "uptier," when a subset of lenders under a facility with only the consent of required lenders extends new debt under the credit agreement to be subordinated in rights to collateral and/or payments.
- A "double dip," when lenders secure multiple claims against a borrower by structuring a loan in a way that creates two separate (but related) debt obligations, allowing them to "double dip" into a borrower's assets in the event of a bankruptcy. Often a double dip involves a non-loan party subsidiary receiving a secured loan and then lending the proceeds to the parent entity via an intercompany loan, with both of the loans secured by guarantees from some entities in the corporate group.
- Preferred equity at a restricted subsidiary raising priming debt. The Pluralsight LMT in 2024 utilized preferred equity financing at a restricted subsidiary to raise priming debt in the private credit market where lenders generally are able to rely on covenant packages and documentation to protect their position.

As a result of the increasing use of LMTs, changes in loan documentation have developed including the JCrew blocker, Serta provisions, Envision blockers, Chewy protection, and other blockers.

Some LMTs have been challenged by the excluded lenders or the lenders whose positions have been adversely affected, and case law is now developing. Two important decisions were issued on December 31, 2024, and it will be interesting to see how they affect future LMTs and credit documentation.

Common Cov-Lite Features

The absence of a financial maintenance covenant for the benefit of the term loan lenders is the core feature of a cov-lite loan. Cov-lite loans often have other borrower-favorable terms that make the restrictions on the borrower more like high-yield bonds than traditional loan transactions with full covenant packages. In particular, cov-lite loans have looser negative covenants. Many cov-lite loans allow the borrower to take one or more of the following actions, subject to certain restrictions:

- **Incur additional debt.** Rather than having a hard dollar cap on the amount of additional debt a borrower can incur, many cov-lite loans allow an unlimited amount of debt above an untested cap if the borrower meets an incurrence test after giving effect to the incurrence of the new debt. Often the incurrence test is a maximum leverage or net leverage ratio or a minimum interest coverage ratio. Additionally, in most cov-lite transactions, if a borrower incurs debt under its fixed incremental basket and its ratio basket at the same time, it can exclude the fixed amount from the ratio calculation.
- **Incur additional secured debt.** Even if a borrower can incur additional debt, additional liens on the collateral may not be permitted by the security arrangements entered into with the initial lenders. However, cov-lite loans typically allow the borrower to grant additional liens to secure newly-incurred debt (thereby diluting the security of the initial lenders), if the borrower meets an incurrence test. Often this test is a maximum leverage or net leverage ratio that applies to secured debt or first lien debt.
- **Incremental debt.** Through most of 2022 and 2023, loan terms shifted in favor of lenders, although from a historical perspective, borrower favorable incremental (and other) debt provisions still prevailed. Given market conditions in late 2022 and 2023 and the inability to obtain new financings, incremental debt offered an opportunity for more borrower favorable terms than a brand new financing; however with higher interest rates, the MFN provisions could have been triggered causing some borrowers to shy away from incremental loans. In 2024, many issuers borrowed incremental term debt to pay down loans outstanding under their revolvers.
  - **Amount of debt**. The fixed amount of incremental debt permitted and not subject to any ratio incurrence test frequently includes a "grower" concept so that the fixed amount is the greater of a dollar amount and a percentage of EBITDA. This provides the borrower with greater flexibility to incur more debt without being in pro forma compliance with the incurrence ratio. The borrower often has the ability to reclassify the incremental debt that was incurred under the fixed amount basket as having been incurred under the ratio basket.
  - **Most favored nation pricing protection.**Rather than maintaining strict protections for existing lenders under incremental debt provisions, many most favored nation provisions (MFN) became more borrower-favorable by (a) completely excluding from the MFN a fixed amount of

incremental debt, (b) permitting a basket of incremental loans to mature sooner after the maturity (or have the same weighted average life to maturity) of the then existing term loans than previously allowed, (c) permitting a higher interest rate spread (50 to 75 basis points or more) between the incremental loans and the then existing term loans, and (d) excluding from MFN protection the proceeds of incremental loans to be used to finance an acquisition. In some multicurrency facilities, the MFN may only apply to term loans made in the same currency as the new incremental loans. A borrower may be able to avoid triggering an MFN pricing provision depending on how a transaction is structured. For example, some MFN provisions may include exceptions for incremental debt that is not widely placed so if a borrower obtains financing from a direct lender, that would generally be treated as meeting that exception. Similarly, some MFN provisions do not cover incremental in-lieu debt (debt raised outside of the incremental or accordion, aka, a "sidecar facility") or ratio debt or may exclude debt in the form of notes, high yield bonds, junior lien or unsecured debt.

  - **Most favored nation on terms.** A "terms MFN" provision restricts the extent to which the overall terms of a new financing can differ from the existing debt unless the existing debt similarly benefits, subject to pre-negotiated carve-outs. Carve-outs can include various fundamental terms such as pricing, interest rate floors, prepayment provisions, fees, amortization, guarantees and collateral.

- **Basket reclassification**. Borrowers are frequently permitted to reclassify indebtedness originally incurred under the initial fixed dollar-based baskets as debt incurred under a ratio-based basket once their financial performance improves enough to satisfy the relevant ratio test. Reclassification permits borrowers that have fully used up their dollar-based baskets to re-load the baskets (that is, provide for additional capacity). Reclassification is often used in both the general indebtedness basket as well as the fixed dollar-based basket in the incremental facility provisions.
- **Mandatory prepayments.** Some borrowers successfully negotiated leverage-based step-downs for the excess cash flow and asset sales subject to mandatory prepayment requirements with the ability to add the retained amounts to the "available basket" that can be utilized, among other purposes, to make restricted payments, investments and to prepay junior debt. According to practitioners, step-downs tend to be more common in syndicated loans. In 2023, lenders were able to negotiate fewer exceptions to the mandatory prepayment requirement and in some cases, also less generous reinvestment rights. Additionally, "soft call" repricing protections weakened in 2023 in some cases by reducing the fee the borrower must pay to lenders in connection with certain repricing transactions undertaken by the borrower or shortening the period of time the protections apply. Borrower friendly terms emerged again in 2024.
- **Pay dividends.** Rather than prohibit dividends or cap them at a fixed amount annually or over the life of the deal, or both, many cov-lite loans allow dividends (much like a typical high-yield bond deal), subject to either a limit based on a percentage of net income or EBITDA at any given time and, in many transactions, on an unlimited basis subject to satisfaction of a leverage or net leverage test.
- **Make acquisitions.** Rather than cap acquisitions at a fixed amount, per acquisition, annually or over the life of the deal (or some combination of caps), cov-lite loans typically allow unlimited acquisitions, subject, in some cases but not all, to the borrower showing pro forma compliance with an incurrence test. Often, in transactions with both a revolving credit facility and a cov-lite term loan governed by the same document, this incurrence test is pro forma compliance with the level set out in the financial maintenance covenant applicable to the revolving credit facility at that time, regardless of whether the covenant is required to be complied with at that time. Other tests may be a maximum leverage or senior leverage test at a level set out in the acquisition covenant. The level may be based on the closing leverage or slightly above or below it. Borrowers continue to negotiate the "no-worse" prong to debt incurrence which allows the borrower to use incremental debt to make acquisitions even if it is not in compliance with the financial ratio so long as the ratio is the same or better after giving effect to the acquisition on a pro forma basis.
- **Repay junior debt.** A common negative covenant in leveraged loans is limitations on repaying a defined class of junior debt. Junior debt may include second lien, unsecured or subordinated debt. Likely, the junior debt is more expensive than the

borrower's first lien debt so it is beneficial for the borrower to pay down the junior debt. Many cov-lite loans allow borrowers to repay junior debt subject to compliance with an incurrence test.

- **EBITDA addbacks.** Borrowers and sponsors continue to obtain historically friendly EBITDA adjustments although toward the end of 2022 and in 2023, EBITDA addbacks became less borrower friendly as a result of a tighter leveraged loan market and a shift to direct lenders, who historically have required a more lender favorable set of EBITDA addbacks than found in the syndicated market. Since most covenant compliance, grower baskets, and potentially pricing are determined by reference to EBITDA, this issue remains heavily negotiated. Current borrower-friendly trends to EBITDA adjustments include: permitting projected cost-savings not connected to acquisitions or reorganizations, increased or removal of caps on pro forma cost-savings synergies, longer look-forward periods, board expenses, severance and relocation costs, synergies "of a type or nature" shown in a sponsor's QOE report, accrued dividends on preferred stock, expenses due to exercise of employee options, indemnification payments that are reimbursable by third parties, and others. In late 2022 and 2023, lenders were able to negotiate smaller caps and shorter periods during which cost-savings synergies could be added back. However, in 2024, borrowers gained the edge and more loans permitted uncapped EBITDA adjustments.
- **Collateral leakage and designation of unrestricted subsidiaries**. As cov-lite agreements have become more borrower-friendly, lenders have grown increasingly concerned about collateral leakage out of the restricted group from whom the lenders are primarily looking to be repaid. Several negative covenants, taken together, provide flexibility for loan parties to move assets to entities outside of the credit group. In this regard, the credit agreement covenants are moving to resemble high-yield bond packages. However, some deals now limit the ability of a borrower to transfer key assets to an unrestricted subsidiary as a result of one high profile transaction where a borrower used this flexibility to move material IP to an unrestricted subsidiary.

In all of these covenants, many times the incurrence-based tests will be additive to the fixed dollar baskets found in traditional credit facilities.

Pros and Cons for Borrowers

Cov-lite loans present the following benefits for borrowers:

- **Reduced risk of default.** Freedom from having to meet financial maintenance covenants allows a borrower to keep its credit facility in place even if the business underperforms relative to expectations as long as interest and other obligations are met. This removes the risks to a borrower of having extended and possibly costly workout negotiations with its lenders to waive or avoid a financial maintenance covenant default, which can result in higher interest rates, payment of fees and loss of negative covenant flexibility. It also lowers the risk of other negative consequences of breaching the financial maintenance covenants including a potential cross-default to other agreements (see Box, Purpose of Financial Covenants: Consequences of Non-compliance). According to PitchBook|LCD's "With LMEs dominating in 2024, payment default rate ends year at 0.91%", the default rate (by issuer count) of the Morningstar LSTA Leveraged Loan Index as of December 2024 was 1.45% which is 1.19% above the record low rate of 0.26% in both April 2022 and December 2007 before the financial crisis, and 0.60% lower than in December 2023. The default rate (by principal amount) was 0.91% at December 2024, down 0.62% from year-end 2023. The 10-year average default rate (by principal amount) for the leveraged loan market is 1.65%, while the historical average (by principal amount) is 2.6%. Per PitchBook|LCD, in 2024, approximately 85% of defaulted loans were cov-lite loans (by outstanding amount at par), and in 2023 approximately 54% were cov-lite while in 2022 it was 91%. PitchBook|LCD surveyed a number of market participants regarding their predictions for the default rate at year-end 2025. The majority, representing nearly 50%, forecast leveraged loan defaults between 1.0-1.49 (with a midpoint of 1.25% which would keep the default rate below its historical average of 2.67%).
- **Greater flexibility.** The looser incurrence style negative covenants that are often included in cov-lite loans enable the borrower to engage in other transactions (such as acquisitions) without having to worry about seeking lender consent, paying consent fees or being unable to obtain the necessary consent.

- **Reduced risk of losing ownership or control.** When a borrower defaults, or might default, it may find that there are divergent goals among its lenders. Traditional lenders such as banks, insurance companies and certain institutional investor categories of lenders, such as CLOs and prime rate funds, may have a goal of repayment in full or having a loan with market terms that will trade at par in the secondary loan market. Other lenders, such as hedge funds and distressed investor funds, may view the ownership of the troubled borrower's debt as a path to owning or taking control of the borrower. The more difficult it is for the borrower to default, the harder it is for the distressed investor to try and obtain control of the borrower.

For a borrower, there does not appear to be many disadvantages in having a cov-lite loan. A borrower may have to pay a slightly higher interest rate for a cov-lite loan, although this is not universally true. A borrower that pays more for a cov-lite loan may end up overpaying if it performs as expected or better and does not use the additional flexibility of the incurrence style covenants. However, the incremental cost, if there is one, is small and the benefits generally seem to greatly outweigh the costs.

Another risk, especially in a transaction with a combined revolving credit and term loan in one document, is the potential for an activist lender to obtain voting power disproportionate to its share of the facility. Because only 50% of the much smaller revolving credit facility (rather than 50% of the entire debt amount (term loan plus revolving facility)) is needed to block an amendment or declare a default, an activist lender can potentially gain greater influence and control over the process with a smaller investment. A borrower may have consent rights over assignments to new lenders, but it may be hard to keep out the activist lender because that right has to be exercised reasonably. To help protect against this risk, many cov-lite loans require borrower consent (at least prior to an event of default or certain defaults such as payment or bankruptcy) for assignments of revolving credit commitments to lenders that only hold term loans. An activist lender is not likely to seek to own the revolving commitment prior to the borrower experiencing distress, so this feature may make it easier for the borrower to keep them out of the revolving credit facility. Disqualified Lender (DQ) lists, which identify competitors and other parties to whom lenders are prohibited from assigning loans or commitments under a loan agreement, also afford protection to borrowers.

Other arguments against a cov-lite loan from the borrower's perspective are theoretical. Some have argued that a borrower and its management benefit from the focus and discipline of having to meet financial maintenance covenants quarterly, and as a result, they may do a better job of maximizing profit. Another argument is that incurrence style negative covenants can allow a borrower to engage in transactions that would otherwise be restricted by a fully-covenanted deal, which may involve taking on too much debt or overpaying for an acquisition.

Pros and Cons for Lenders

From a lender's perspective, cov-lite loans may dilute many key lender protections, such as:

- **Early warning of payment default.** The early warning provided by the periodic financial maintenance covenant can alert lenders in advance of a possible payment default or bankruptcy.
- **Avoiding unfavorable transactions.** The lack of limits otherwise provided by tighter negative covenants can allow the borrower to enter into transactions that are not beneficial to the lenders.
- **Security interest in collateral.** The ability of the borrower to incur additional secured debt may dilute the lenders' collateral coverage for their loans.
- **Priority over junior creditors.** If the borrower is permitted to repay higher-cost junior debt prior to a default on the lower-cost credit facilities, the senior lenders would then have to work out loans with an underperforming or over-leveraged borrower without the cushion of the junior debt (whose repayment depleted the borrower's available cash).

In a fully-covenanted transaction, if the borrower cannot meet its financial maintenance covenants or wishes to engage in a transaction that the negative covenants prohibit, the borrower and the lenders can negotiate a waiver or amendment. In these negotiations, the lenders, acting as a group, have the option to provide relief in return for concessions by the borrower that either compensate the lenders for increased risk (such as increased interest and fees) or further protect the lenders through tighter covenants or new events of default. The lenders also have the option to refuse to provide relief and try to exercise remedies or precipitate a bankruptcy. In a cov-lite deal, these options are significantly reduced.

For a Note describing the process of amending a syndicated loan agreement, see Practice Note, Loan Agreement: Amendments.

The benefits for lenders in a cov-lite loan seem to be more limited. As discussed, the lenders may (but may not) receive a higher yield than in a fully-covenanted loan. However, other benefits seem to be highly theoretical. One argument is that the lenders may ultimately enjoy a greater recovery if an underperforming borrower is given time to improve its performance without the pressure of financial maintenance covenants and the costs and distractions of a workout. Competition to invest capital, including the large amount of cash available to private equity firms, has led to record new issuances and refinancings and to an increased trend towards cov-lite terms in the direct lending market.

Purpose of Financial Covenants

Financial covenants are one of the key protections for lenders in a leveraged loan transaction. Syndicated loan transactions generally are either investment grade or leveraged. Leveraged loans are perceived to have greater credit risk than investment grade loans.

Most often the distinction is determined by the rating on the loan from a rating agency. A loan with a rating in one of the four highest rating categories is typically considered an investment grade loan. A loan with a rating below the four highest categories is a leveraged loan. A loan without any rating can also be categorized as investment grade or leveraged based on how the borrower's credit profile, including its leverage ratio or interest or fixed charge coverage ratio, compares to rated loans for similar borrowers.

Because of their perceived greater credit risk, leveraged loans typically have greater protections for the lenders. These protections include, but are not limited to:

- Guaranties and security interests from the loan parties.
- Negative covenants limiting voluntary activities by the loan parties such as incurring indebtedness, selling assets, making investments or acquisitions, paying dividends or prepaying or repaying other indebtedness.
- Mandatory prepayments from the borrower from asset sales, excess cash flow and certain other events.
- Financial maintenance covenants to be satisfied by the borrower.

Common Financial Maintenance Covenants

Financial maintenance covenants require a borrower to meet certain financial performance criteria periodically, usually quarterly but sometimes monthly. Failure by the borrower to meet the financial performance criteria can result in a default under the loan documents which potentially can have several adverse consequences (see Consequences of Non-compliance).

There are many types of financial maintenance covenants, but the most common are tied to an agreed definition of the borrower's cash flow available for debt service. Often this is defined as EBITDA (earnings before the deduction of interest, taxes, depreciation and amortization). Common financial maintenance covenants are:

- **Maximum leverage ratio.** The borrower must not exceed a specified ratio of debt to EBITDA (or some other cash flow measure). Depending on a borrower's capital structure and market conditions at the time of the loan, leverage tests can apply to total debt, secured debt, senior debt, senior secured debt or first lien debt, and the loan agreement may include a combination of leverage tests. Many times a net leverage ratio is used, which gives the borrower credit for unrestricted cash on its balance sheet, sometimes up to a cap and other times unlimited.

- **Minimum interest coverage ratio.** The borrower must, at a minimum, meet a specified ratio of EBITDA (or some other cash flow measure) to interest expense. As with leverage tests, depending on a borrower's capital structure and market conditions at the time of the loan, interest coverage tests can apply to total interest or only cash interest that is payable on total debt, secured debt, senior debt or first lien debt, and the loan agreement may include a combination of interest coverage tests.
- **Minimum fixed charge coverage ratio.** The borrower must, at a minimum, meet a specified ratio of EBITDA (or some other cash flow measure) to an agreed definition of fixed charges. Some of the items that can be included in fixed charges are interest expense, capital expenditures, dividends and other distributions and scheduled payments of principal. In some deals, several of these items may be subtracted from EBITDA in the numerator of the ratio rather than included in the fixed charge denominator.

For more information on financial covenants, see Practice Note, Loan Agreement: Financial Covenants. For Standard Clauses for financial covenants, with explanations and drafting and negotiating tips, see Standard Clauses: Loan Agreement: Financial Covenants.

A leveraged loan that has financial maintenance covenants may have one, some or all of the covenants described above. The definitions and required ratio levels are set when the loan is negotiated. Normally, the required ratios are based on financial projections prepared by the borrower for the lenders plus a cushion on top of the projected performance. The purpose of financial maintenance covenants is to provide the lenders with an early warning that the borrower is not performing as expected and that action to improve performance or adjust the loan terms may be needed.

Financial maintenance covenants apply periodically at the times they are required to be tested, usually at the end of a quarter or, sometimes, at the end of a month.

The borrower is required to comply with the financial maintenance covenants regardless of whether it is looking to engage in a transaction restricted by its negative covenants or is currently able to pay its debt service and other obligations when due.

In contrast, an incurrence-based negative covenant only applies when a borrower wants to voluntarily engage in a transaction or activity restricted by that covenant. An incurrence-based negative covenant prohibits a borrower from those actions only if it does not comply with the specified incurrence test. Therefore, a borrower that is underperforming relative to its projections can avoid violating its incurrence-based negative covenants by not engaging in the activities restricted by those covenants.

For more information on negative covenants, see Practice Note, Loan Agreement: Negative Covenants. For Standard Clauses for typical negative covenants, with explanations and drafting and negotiating tips, see Standard Clauses, Loan Agreement: Negative Covenants.

Consequences of Non-compliance

Failure to comply with financial maintenance covenants can have serious and adverse consequences for a borrower. In almost all loan agreements with financial maintenance covenants, failure to comply with any one of them will result in an immediate event of default under the loan documents.

One exception to this rule is if the loan agreement has an equity cure right. This right gives the borrower's parent company a right to contribute equity to the borrower in an amount that, when added to EBITDA, would cause the borrower to be in compliance with the failed financial maintenance covenant.

Equity cure rights, while not uncommon, are not a panacea for a borrower that is failing a financial maintenance covenant. The equity owners might be unable or unwilling to exercise the right, especially if the amount needed to cure is large or the borrower is expected to fail the financial maintenance covenant again on future test dates. In addition, the use of equity cure rights may be limited by the terms of the loan agreement. Although these rights are highly negotiated and vary from deal to deal, there are often limits on the number of times and the number of consecutive times they can be used. There may also be limits on the size of the equity cure amount, either individually or in the aggregate.

Generally, loan agreements treat all events of default more or less equally. Upon an event of default, lenders have the right, among others, to demand immediate repayment by accelerating the debt and to exercise collateral remedies. In practice, however, market participants do not treat all defaults with the same level of gravity. The most serious are payment and bankruptcy defaults. The next most serious are financial maintenance covenant defaults because they are a warning that a payment default or bankruptcy might be impending for the borrower.

The consequences for a borrower of a financial maintenance covenant default are numerous and varied and will depend on several factors, including the specific terms of the borrower's loan agreement and the composition of the lender group. The consequences of a financial maintenance covenant default can include:

- **Loss of liquidity.** In a loan agreement with a revolving credit facility, it is usually a condition precedent that no default or event of default exists at the time a new loan is made.
- **Reputational damage.** If the borrower is a public company or has public debt outstanding, it may have an obligation to disclose any breach of a financial maintenance covenant. Depending on the nature of the borrower's business, this disclosure can cause customers to leave and go to competitors who are perceived to be more financially sound. It can also cause suppliers to tighten credit terms, potentially further straining the borrower's liquidity.
- **Increased interest costs.** Many leveraged loan agreements require (or may allow lenders to require) the borrower to pay a default interest rate on its overdue loans. This rate is often a 2% per annum increase over the non-default rate. The borrower may also have to start using a higher index for determining its interest rate (such as base rate instead of LIBOR). Both of these consequences can potentially further strain the borrower's liquidity.
- **Cross-default.** A financial maintenance covenant default in one loan agreement may result in a cross-default in some or all of a borrower's other indebtedness. This can lead to greater pressure for protective bankruptcy filings to fend off aggressive creditors.
- **Distraction to management.** Management may need to spend significant time negotiating an amendment, restructuring or workout of the loan terms in order to waive a financial maintenance covenant default. This can distract management from running the business or fixing the problems responsible for the underperformance.
- **Acceleration.** The lenders may choose to accelerate their debt and demand repayment, which is very likely to lead to a bankruptcy filing.

In addition, if a borrower cannot meet its financial maintenance covenants or, possibly, if prior to a default a borrower cannot show its auditors projected compliance, the auditors may issue a "going concern" qualification in its annual audit because of all the consequences that can result from an event of default. In most leveraged loan agreements, this alone may cause an event of default because of a requirement for the borrower to deliver an unqualified audit. As a result, depending on the timing of when a borrower is no longer able to show projected compliance with its financial maintenance covenants, a borrower may have a default tied to its financial maintenance covenants long before it actually fails a test. Accordingly, since term lenders do not get the benefit of a springing covenant, the loan agreement in some cov-lite transactions may provide that it is not a default if the annual audit includes a qualification based only on the borrower's projected non-compliance with the financial maintenance covenants.

For a Note explaining events of default in loan agreements, including the rights and remedies of lenders, see Practice Note, Loan Agreement: Events of Default.

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