Cov Lite: The other side of the hill

"The whole art of war" said the Duke of Wellington, "consists of guessing what is on the other side of the hill".

Similarly in corporate distress, anticipating what the borrower and the other protagonists will do, figuring out what is going on over the brow of the hill, is crucial to pursuing a strategy to restructure the borrower that will work.

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In the article "A Heavyweight Solution to Cov Lite" (Global Turnaround, March 2019) I pictured an image of seething lenders, enfeebled by the absence of financial maintenance covenants, unable to compel a leveraged borrower to undertake a restructuring. While the lenders fume, the borrower is blithely unconcerned, and allows the company to spiral down into failure, not waking to reality until it's too late.

But is this an accurate picture of what is really happening on the other side of the hill? I'm going to suggest that while Cov Lite enables borrowers to ignore their lenders, that doesn't mean that the borrowers won't be acting to deal with the financial crisis.

Anyone who has worked in the restructuring or insolvency business will have repeatedly seen poor management as the cause or, at least, the proximate cause, of a corporate bust.

> Good businesses are regularly killed by poor management.

For the dogmatic, inflexible and selfish among managements, that their company is under few covenantal constraints is a gift. They can cling to a business model and vision of wealth and success that are increasingly delusional. The nightmare for investors seems inevitable.

Always look on the bright side

Corporate managements, of course with exceptions, are not dishonest and strive not to be negligent.

For over 30 years, the tenor of UK law has been to incentivise or terrorise directors into opting for corporate rescue or, at least the survival of the business, before it is too late.

But directors who design and implement their company's strategy are peculiarly vulnerable to confirmation bias, seeing in the facts and figures about their company's performance only the evidence that shows their plan is the best and will work.

If, on top, the CEO is a charismatic leader who views criticism as disloyalty and a lack of commitment, then the helmsman won't be watching the compass.

But, these days, for a particular subset of companies that numbers in the thousands, this isn't a true picture of how they are run and how they react to crisis. These are the Private Equity (PE) portfolio companies.

We must start by remembering that PE works; it makes money, adds value, and pension and insurance companies as well as wealthy individuals invest in PE funds because they make money (see the 11th "Annual report on the performance of portfolio companies December 2018" by EY).

Secondly, boards of PE portfolio companies are different.

Research shows they are less focused on process and committee work, they have better information and there are no taboo topics in their deliberations (Cheffins and Armour "The Eclipse of Private Equity").

> The PE fund invests because it can see an opportunity to generate and realise significant value over a limited timeline of, usually, no more than five years.

The PE fund nominates directors to the board, professionals committed to success but not so at the risk of being confounded by emotional bias and wrecking their careers as directors.

Executive management, often assembled as a team by the PE owner, are professionals, too, and incentivised to achieve success. Presented with a problem of performance, the board of a PE portfolio company will search for a solution.

Watch out for directors' liability

However, this doesn't mean that the absence of financial maintenance covenants (FMC)

doesn't matter.

There are powerful arguments for FMCs and the only reason they have become rare is because of the bargaining power of borrowers, not because they don't serve a purpose.

The market has been overflowing with cash, producing a savage competition between lenders, which has in turn led to diluted covenants and lending standards. Even then the margins achieved by lenders have been poor.

But there is equally an argument that the boards of PE portfolio companies will nonetheless heed economic warnings, whether or not those warning signs are likely to trigger a covenant breach.

> Moreover, boards will undertake restructuring as necessary even at the cost of the very equity investment that the PE fund has made.

Professional directors and the general counsels of PE funds are very well aware of the milestones that mark the road to corporate failure.

These are the turning points after which the decisions of boards and individual directors will be subject to intense scrutiny. The search will be on for grounds of personal liability for the director, and transactions that can be unwound in insolvency.

Emphasis of matter, qualifications to going concern wording, falls in EBITDA or profit or revenue, lengthening debtor days, sales decline, all these can serve as an inflection point, the moment at which a director should have acted differently, reviewed strategy; each is a moment after which disposals and repayments, and the taking of new credit and payment of dividends, may be vulnerable to a costly and career-breaking attack.

The grey area of insolvency

Creditors are not, however, going to be easily persuaded that they can relax and leave identifying and responding to a problem to the incumbent management. They know that the board, its PE nominees and incentivised mismanagement will be, understandably, reluctant to abandon the equity.

They know that the terms of the company's borrowings will commonly allow a comparatively modest equity top-up to avoid breach of the debt-to-EBITDA ratio, one of the few FMCs that survive into current 'Cov Loose' deals.

> The board's lawyers will remind it that, as insolvency becomes a probability, the directors' duties require them to consider and act in the interests of creditors.

That doesn't mean that out of all the strategies that might reasonably be adopted, one that also preserves value for shareholders shouldn't be chosen. There is evidence that PE portfolio companies are more prone to exposing bondholders to increased risk.

In the Sequana case (BTI 2014 LLC v Sequana SA (2019)), Lord Justice Richards declined to hold that when the directors' primary duty to promote the success of the company means looking to the interests of the creditors, it is those interests that are paramount, beating the shareholders' interests into second place.

He also remarked that when the company is actually insolvent and the directors know or ought to know that, it was hard to see how the duty to creditors could be otherwise than paramount.

A sceptical eye on lenders

Directors will turn an equally sceptical eye on lenders.

In distress, are the lenders really focused only on getting repaid? When they call for specific action by the board of directors and the sponsor, do they harbour more ambitious strategies?

The board will look at investors who have bought into the debt at a discount and figure that their motives are just to make a turn when the price rises, or that they have a loan-to-own strategy, or that they've bought credit default swap (CDS) protection and will, in fact, make money from the borrower's failure.

In short, the investors' motives aren't altruistic either. This is not about moral judgments but about the dynamics, the pressures and pragmatic realities that drive the board, the debt holders and the shareholders, when a company is in financial crisis.

Cov Lite gives boards plenty of room for manoeuvre, but they are still constrained by legal duties that professional PE nominee directors take seriously.

Understanding this, and the particular circumstances of the debtor, is a 'view over the brow of the hill'.

The absence of FMCs allows directors to drag their feet in reacting to problems but it doesn't remove those legal duties whose breach becomes more likely and more acute as time is allowed to pass.

A failing business is a failing business, whether or not the inevitable can be put off for a time, or held at bay, by injecting squirts of equity.

Insolvency law doesn't forgive breaches of duty because the management have managed to put off the day of reckoning.

> In the benign market of massive liquidity and abundant cash, a strategy of delay, kicking the can down the road, may not be right but it isn't crazy.

There has been abundant cash, so distressed businesses have been able to rely on finding either an acquiror or a new investor. But when the market flips from bull to bear, when sentiment changes, when values drop, that thinking is exposed for its fallaciousness.

Understanding these concerns and pressures means that the concerned lender and the well-advised debtor might start a sensible conversation and find a way to cooperate. The muscularity of a dogmatic approach to restructuring that is only voiced through a megaphone and at daggers drawn ignores the power of a determined but unhistrionic tactical approach, aiming to find common ground.

Of course that leaves plenty of scope – and need – to show that while one speaks softly, one carries a big stick.

The more you can figure out what the borrower and its shareholders are thinking, the more effective will be the restructuring.