WHITE & CASE

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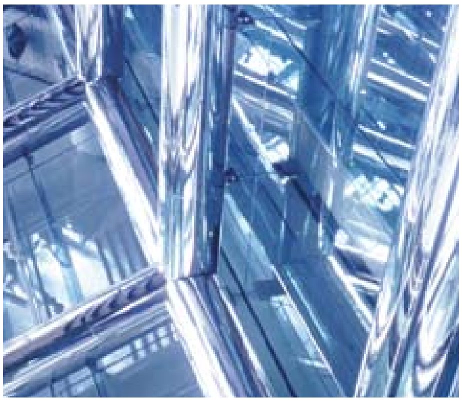
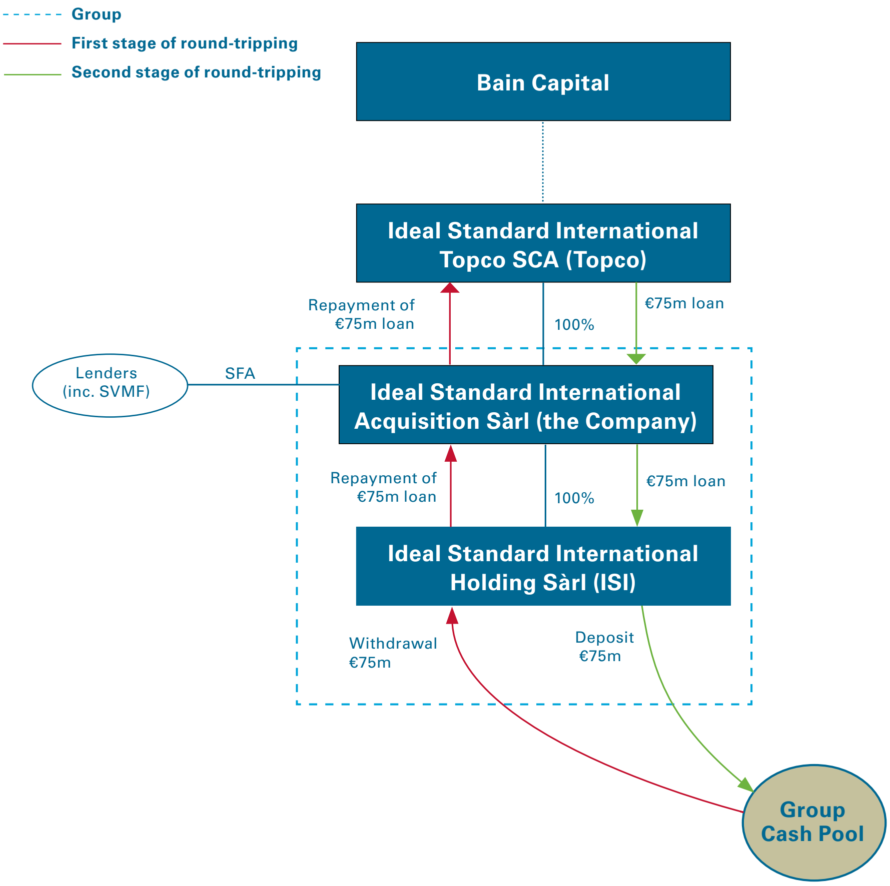
Equity Cures: An Ideal Standard?

Equity cure provisions, a common feature of leveraged facilities agreements, allow an injection of capital into the group to stave off or 'cure' a financial covenant default. When lenders agree to include such provisions they generally take comfort from the fact that, in exercising them, sponsors will inject further equity or subordinated debt into the group, providing both additional funds and a show of commitment. The recent decision in *Strategic Value Master Fund v Ideal Standard International Acquisition SARL and others*[1] gives lenders cause to take extra care when including such provisions in facilities agreements.



Equity cure



For more information please contact:

R. Jake Mincemoyer
Partner, London
+ 44 20 7532 1224
rmincemoyer@whitecase.com

Jeremy Duffy
Partner, London
+ 44 20 7532 1237
jduffy@whitecase.com

Gareth Eagles
Associate, London
+ 44 20 7532 1251
geagles@whitecase.com

Kate Andrews
Professional Support Lawyer, London
+ 44 20 7532 1249
kandrews@whitecase.com

Michael Mount
Associate, London
+ 44 20 7532 1485
mmount@whitecase.com

1 [2011] EWHC 171 (Ch)

The claimant ("SVMF") lent money to the defendant (the "Company") pursuant to a senior facilities agreement ("SFA") as one of the lenders in the syndicate party thereto. Later, the Company breached its financial covenant obligations under the SFA. The equity cure provision allowed cash proceeds in the form of 'New Equity' or additional 'Subordinated Debt' provided to the Company to be added to the amount of EBITDA for the relevant periods for the purpose of re-calculating the financial covenants and "curing" such breach.

A member of the group ("ISI") withdrew €75m from a group cash pool and with this prepaid an outstanding inter-company loan owed by ISI to the Company. The Company in turn used the proceeds to prepay loans owed by it to, and redeem certain equitable instruments issued to, its parent company ("Topco"). It is important to note that Topco was outside the Group for the purposes of the SFA. Topco then immediately lent the €75m back to the Company, who on-lent the money to ISI to replenish the cash pool.

This series of transactions was held to constitute the lending of additional subordinated debt, which could be added to EBITDA and the financial covenant breaches "cured", notwithstanding that no new money had been injected into the Group and the commercial purpose of the "equity cure" clause had arguably not been achieved. It was argued in court that the commercial purpose of the clause involved new money being injected into the Group to improve its "financial health". The judge tackled this argument directly, noting that the equity cure provisions contemplated funds being injected either by way of equity or by way of subordinated debt. Lewison J's view was that "a company in financial trouble would not usually be regarded as improving its financial health by going further into debt … [it] would be like paying one's mortgage interest by using a credit card", and he consequently rejected the argument that the "equity cure" provision's purpose was the improvement of the Group's "financial health". A proper consideration of that analysis requires some reflection on what we mean, or ought to mean, when we consider the "financial health" of a company in this context.

It is generally understood that "equity cure" provisions are a concession to sponsors. At their request, "equity cure" provisions are included in documents so that sponsors may avoid events of default that might otherwise arise as a result of financial covenant breaches. In a deal without an "equity cure" right, a financial covenant default might lead to negotiations with lenders, to an amendment or waiver process, or to enforcement proceedings. Where deal documents contain an "equity cure" right, sponsors have an opportunity, before any such consequences arise, to decide whether to 'fix' the problem by injecting additional funds. It is possible to describe that opportunity as a chance to improve the "financial health" of the Group – but only if we give that term a very specific meaning. An improvement in "financial health", in this context, ought not to mean an abstract improvement in the Group's financial condition: the Group's economic interests may be somewhat aligned with those of the senior lenders, but they are not, especially in a potential default scenario, the same. Rather, it ought to mean an improvement in the Group's ability to service its senior debt and comply with its obligations to the senior lenders. That is the generally understood purpose of equity cures. It is not a one-sided reading of their purpose - it is the purpose to which they must be directed if lenders are to derive anything from the bargain when they agree to concede equity cure rights to sponsors. The injection of subordinated debt, provided that it is truly subordinated, achieves that purpose and does not denigrate from it. This argument does not appear to have been made before the judge.

However, a sensible response to this case is not merely to complain about the commerciality or otherwise of the decision; rather, it is to remember that the courts may indeed not understand lenders' intentions if not expressed clearly enough.

Conclusion

Lenders should ensure that equity cure provisions are sufficiently tightly drafted so as to avoid "round tripping" or other artificial scenarios being effected to cure financial covenants. Unless such provisions are carefully constructed, the protection afforded to lenders by financial maintenance covenants, and the early warning of trouble that they can provide, may prove to be non-existent.

There is no LMA "equity cure" provision and no other standard definition. Some deals require that any equity cure proceeds be applied to prepay the senior debt. Where this is not the case, it may be sensible to state expressly that any equity cure is made by way of new moneys from a source outside the group (or any group holding company), to regulate tightly the terms of such injection, and to ensure that regulation of cash leaving the group is, subject to any deal-specific exceptions, watertight. It is clear from this case that one should not assume that the courts will second-guess the commercial intention of the parties if the documents on their face leave room for doubt.