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Debt covenant renegotiations and creditor control rights ☆

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ABSTRACT

Using a large sample of private debt renegotiations from 1996 to 2011, we report that, even in the absence of any covenant violation, debt covenants are frequently renegotiated. These renegotiations primarily relax existing restrictions and result in economically large changes in existing limits. Renegotiations of specific covenants are a response to both the distance the covenant variable is from its contractual limit and the firm's specific operating conditions and prospects. Moreover, the borrower's post-renegotiation investment and financial policies are strongly associated with the covenant changes resulting from the renegotiation. Overall, the findings imply that, even outside of default states, creditors have strong control rights over the borrower's operating and financial policies, and they exercise these rights in a state contingent manner through covenant renegotiations.

1. Introduction

The traditional view of debt governance assumes that creditors remain silent on managerial decision making outside of those states in which there is a payment default. More recently, an alternative view of debt governance argues that, even in the absence of a payment default, a technical default (i.e., covenant violation) can similarly transfer control rights to the creditors. This literature reports significant constraints placed on managerial discretion over important corporate decisions following covenant violations (i.e., Chava and Roberts, 2008; Roberts and Sufi, 2009a; Nini, Smith, and Sufi, 2012). Under both of these views, a default (i.e., either a missed payment or a technical default) is necessary to trigger the transfer of control rights to creditors. Moreover, the exercise of these control rights involves creditors placing tighter restrictions on debtors.

In this study, we analyze the renegotiation of debt covenants to assess the extent to which creditors exert influence over important firm decisions in a broader set of states, including those with neither a payment default nor a covenant violation. We provide evidence on three primary questions: (1) How frequently, and in what direction, are debt covenants renegotiated outside of any sort of default? (2) What are the determinants of these renegotiations? (3) What impact (if any) do covenant renegotiations have on the subsequent behavior of the borrower?

Prior theoretical studies that explore creditor control rights in an incomplete contracting setting emphasize the possibility of renegotiation as an important element of debt contract design. As originally argued in Hart and Moore (1988), debt contracts are inherently incomplete because of the difficulty that outsiders face in verifying important information (e.g., asset values and project payoffs) that is critical to loan values. Aghion and Bolton (1992) emphasize that, in such a setting, the allocation of control rights becomes critical. Debt contracts assign these control rights primarily through covenants that transfer decision rights from shareholders to creditors in

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certain states of the world (e.g., Chava and Roberts, 2008; Roberts and Sufi, 2009a). However, these covenants can be renegotiated when new information arrives if doing so results in Pareto improvements from modifying the original contract. Such renegotiation could be triggered by technical default (e.g., Smith and Warner, 1979; Beneish and Press, 1993; Chen and Wei, 1993), but, as noted in Aghion and Bolton (1992), that need not be the case. A shift in control rights to creditors can be conditioned on a much broader set of signals about future states of the world. Moreover, although creditor interventions triggered by default typically imply additional constraints on managerial actions, the exercise of creditor control rights outside of default need not do so. In the model of Garleanu and Zwiebel (2009), asymmetrically informed borrowers and lenders deliberately set covenant limits to be restrictive at the time of loan origination. Subsequent renegotiations are then more likely to loosen covenant limits. Despite the theoretical importance of debt contract renegotiations, empirical evidence on the frequency, magnitude, determinants, and implications of debt covenant renegotiations remains limited.

Our sample begins with a random set of one thousand credit agreements initiated between 1996 and 2005. For this set, we search Securities and Exchange Commission (SEC) filings and collect all renegotiations of the debt contract over the life of the contract or until August 2011, whichever comes sooner. These renegotiations consist of both renegotiations of the three primary terms of the loan (amount, interest rate, and maturity) and renegotiations of covenants. We focus our analysis on the frequency with which certain restrictive and financial covenants in these agreements are renegotiated and the resulting renegotiation outcomes.

We report several findings consistent with the view that covenant renegotiations represent an important channel through which creditors exert control outside of default. First, covenant renegotiations occur frequently and represent economically meaningful changes in constraints on managerial decisions. Specifically, we find that 53% of all debt contracts and 76% of all debt contract renegotiations modify at least one of the restrictive or financial covenants that we study. Importantly, the majority of the renegotiations are not associated with any reported technical default. Over 60% of the covenant renegotiations relax previous restrictions, whereas less than 30% of the covenant renegotiations tighten the existing restrictions. On average, the absolute values of changes to debt covenants range from over 30% to over 80%.

Second, we collect detailed information on the contractual limits of two specific covenants–those restricting capital expenditures and those specifying a maximum debt to earnings before interest, taxes, depreciation, and amortization (Debt/EBITDA) ratio–and how the covenant variables evolve relative to their contractual limits over the life of the contract. This analysis reveals that, among the set of covenants whose thresholds are relaxed, covenant variables evolve significantly closer to their limits between the time of loan origination and the time of renegotiation. Moreover, without the relaxation in covenant limits, approximately 50% of the covenants would be in violation of covenant requirements. In contrast, among covenants whose thresholds are tightened, we find that covenant variables have evolved away from their limit since loan origination and that renegotiations effectively bring covenant restrictiveness back to its original level. These findings are robust to controls for the arrival of new information, as measured by changes in the firm characteristics and macroeconomic conditions studied in Roberts and Sufi (2009b). If a covenant is about to be violated in a given year or quarter, its limit is significantly more likely to be relaxed through renegotiation before the violation occurs.

Nonetheless, when covenant variables evolve close to their contractual limit, renegotiations of covenant limits are far from automatic. In a majority of these cases, covenants are not relaxed. Consistent with a state-contingent exercise of control rights, our evidence indicates that creditors take into account the borrower's specific operating conditions and prospects when making this decision. We find, for example, that among those cases in which planned capital expenditures would exceed current covenant limits, changes in those limits are positively associated with a measure of the quality of the borrower's investment opportunities. Similarly, the relaxation of Debt/EBITDA covenant limits is positively associated with our proxy for whether an observed decline in profitability is temporary.

Finally, we examine the association between debt covenant renegotiations and the borrower's subsequent investment and debt issuance decisions. We find that post-renegotiation capital expenditures are positively associated with the extent to which capital expenditure restrictions are changed in the debt contract renegotiation. Specifically, relaxations of capital spending restrictions are followed by levels of investment that are greater than the previous covenant limit, while the tightening of capital spending restrictions is followed by investment that is lower than the firm's previous limit on capital expenditures. Similarly, we observe increases in debt issuance after Debt/EBITDA limits are relaxed and reductions in debt issuance after Debt/EBITDA limits are tightened. In addition, among those firms whose actual capital expenditures or Debt/EBITDA ratios are a similar distance from their covenant limits, firms for which covenant limits are relaxed make significantly greater investments and issue significantly more debt than firms for which covenants are not relaxed.

Overall, therefore, our findings indicate that, even outside of default, creditors exercise control rights in a state-contingent manner through covenant renegotiations and these renegotiations have a meaningful influence on subsequent managerial decisions. In this sense, our results complement and extend those of prior empirical studies that analyze the consequences of covenant violations.[1] These studies show that the transfer of control rights to creditors after such violations generally puts additional constraints on managerial discretion over corporate investment and financing policies. Our findings imply not only that creditors exercise control rights prior to any covenant violation, but also that they do so in a flexible manner, either tightening or loosening constraints on managerial discretion depending on the debtor's circumstances.

[1] See, for example, Beneish and Press (1993) and Chen and Wei (1993) for early evidence on the decision by creditors to modify contract terms and grant waivers to debtors in situations of technical default. For more recent evidence on the consequences of covenant violations, see Chava and Roberts (2008), Roberts and Sufi (2009a), and Nini, Smith, and Sufi (2012).