THE ROLE AND SYSTEM OF BUSINESS COVENANTS – FOCUS ON PRACTICE IN SLOVAKIA

By
Matus Valkucak

Submitted to
Central European University
The Legal Studies Department

Supervisor: Professor Tibor Tajti

Budapest, Hungary
2012

ABSTRACT

The main purpose of this thesis is to answer question whether the system of business covenants has been introduced in the banking practice in Slovakia. In achieving this aim, it will evaluate the system of business covenants as was developed in common law and analyze the model covenants provisions focusing on their function. Additionally, based on the analysis of the concept of covenants in connection with their role in solving of the conflict between stockholders and investors, it will explain what the understanding of this concept in civil law system is. Author comparing the usual set of covenants existing in loan agreements in United States finds that the most typical covenants also exist in loan agreements in Slovakia. Furthermore, he finds that these covenants take the standardized form and he will outline which covenants are used in general terms and conditions of Slovak banks.

Table Of Contents

INTRODUCTION

The business covenants are one of the means through which business entities, mainly bankers in extending credits to their clients, or bondholders in subscribing to bonds, protect themselves and ensure that their investment would be successful and they will be repaid earning some profit. They represent voluntary constrains ordering or restricting the firm, in which investor invested his money, from certain actions. Although they do not directly enable the satisfaction of the investor's claims as other security interest, various authors, such as Bratton, Smith and Warner[1], claim that they help to solve the conflicts between investors and the stockholders of the firm and as such they enhance position of investors. There are also several studies, such as one by Paglia, which investigate covenants existence in particular loan agreements[2].

From the literature examined, it is no doubts that this concept is typically used in business practice in common law. Below, it will be also pointed out that, scholars in some civil law jurisdictions also analyze this concept focusing on the practical issues. Save to some economic literature on calculation of financial covenants, the Slovak literature is however in this regard silent. Therefore in this thesis I will confirm that the practice in Slovakia also uses this concept and I will specify which particular covenants are used and what is their usual wording. After reading this thesis, a reader from civil law jurisdiction might understand what the role of the "boilerplate" covenants provisions is and where they come from.

This thesis is divided on three chapters. First chapter deals with mainly theoretical issues, it will outline the area in which business covenants are used, explain their function and will evaluate the civil law concept. Second chapter will elaborate the standard set of covenants used in US focusing on typical covenants founded in loan covenants. The descriptive nature of this chapter is necessary in order to provide the set of covenants

[1]William Bratton, *infra* note 13.
[2] Paglia, *infra* note 79.

developed in US, for comparison with the practice in Slovakia. Last chapter will focus on practice developed in Slovakia. It will analyze the general terms and conditions and loan agreements used in practice by Slovak banks in providing loans and it will point out particular covenants used therein.

CHAPTER 1 – COVENANTS IN GENERAL

The crucial term of this work is the term "covenant" and in order to comprehend its equivalent in civil law, it is important to understand this concept under common law. Therefore section 1.1, will provide definition of this term and outline how the covenants were developed under common law. This thesis is dedicated to covenants in financial sector and therefore next I explain the understanding of the term "business covenants". Since in chapter 3, the covenants in Slovakia are analyzed, section 1.2 will evaluate, how covenants are used in civil law system. Finally, as it will be shown that the function of business covenants determine this term, in section 1.3, I will introduce the roles of the business covenants based on the solution of the stockholders-investors conflict and in section 1.4 I will continue with the consequences of the covenant's violation.

1.1 Definition of Covenant

Black's law dictionary – reflecting primarily the meaning of legal terms in the law of the United States (hereinafter: US) – defines the term "covenant" as "[a] formal agreement or promise, usu. in a contract or deed, to do or not do a particular act."[3] The other common legal definitions of this term are coherent with the Black's definition in that they also qualify this term as an agreement or promise consisting of doing some actions, or omitting from doing some actions.[4] The person making the promise is called a *covenantor* and the person to whom such promise is made is called a *covenantee*. However, as will be seen the rest of the thesis, such names are rarely used and the designation of the parties is rather determined by the nature of the contract which includes a covenant, such as lender and borrower in a loan agreement. One definition also points out the difference between the covenant and the

[3] Black's Law Dictionary (9th ed. 2009).

[4] *Cf*. "[a]n agreement, contract, or written promise… to do or refrain from doing something." *West's Encyclopedia of American Law* (2nd ed. 2008), or "[a] covenant is any agreement between parties outlining the relationship in legal terms and actions promised to take place or to refrain from doing." Bill Roark & Ryan Roark, *Concise Encyclopedia of Real Estate Business Term* (1st ed. 2006), p. 30, or " a covenant is an agreement … whereby either party stipulates for the truth of certain facts, or promises to perform or give something to the other, or to abstain from the performance of certain things." John Bouvier, *A Law Dictionary* (6th 1856). Available at http://www.constitution.org/bouv/bouvier_c.htm.

contract in that way that the "covenant, in contrast to a contract, is a one-way agreement whereby the covenanter is the only party bound by the promise … [c]onsequentially, the only party that can break a covenant is the covenanter."[5]

As Black's definition suggests, the covenants can be affirmative or restrictive (sometimes latter called negative). [6] According to the traditional distinction, an affirmative covenant "is one by which the covenantor binds himself that something has already been done or shall be performed hereafter," and a restrictive covenant is "one where the party binds himself that he has not performed and will not perform a certain act".[7]

Traditionally, the general requirements for conclusion of the covenant under common law were similar with the requisites for conclusion of the contract.[8] The distinctive feature of the covenants was special form's requirement either of deed or under seal. This requirement stems from the twelfth century, when the agreements were enforced by the courts only if appropriate writ existed. For the purpose of this thesis, the *writ of covenant* is relevant. This writ could have been used only with agreements incorporated in written documents accompanied with a seal. Therefore the agreements made under seal were called covenants.[9] Other agreements were enforced based on the *writ of assumpsit* regardless of their form, but provided that they had "consideration". The covenants did not require consideration, but on

[5] Definition of the covenant on the internet. Available at. http://covenant.askdefine.com.

[6] Save to the classification on the positive and negative covenants, I consider other types of classifications of covenants in their general meaning as not important and I will only briefly note following: the (i) express or implied covenants, (ii) real and personal covenants, (iii) principal and auxiliary covenants, (iv) executed or executor covenants, (v) obligatory or declaratory covenants *etc*.. John Bouvier, *supra* note 4. In the rest of this thesis, I will focus on covenants in financial sector, in which various other classifications are being used. These classifications will be described in the relevant parts of this thesis dealing with those covenants.

[7] John Bouvier, *supra* note 4.

[8] John Bouvier in the section of his famous work regarding to the covenants states that these requirements are (i) proper parties, which have sufficient legal capacity, (ii) words of agreement representing mutual assent, however no specific words were required, (iii) a legal purpose which must not be against any positive law, or public policy, or otherwise void and (iv) special form. John Bouvier, *supra* note 4.

[9] "[T]he law considered the sealed instrument as not merely evidence of an obligation but as the obligation itself … the action of covenant at common law came to be used to enforce "formal" contracts made under seal. These promises under seal were called … covenants." Eric Mills Holmes, *Stature and Status of a Promise under Seal as a Legal Formality*, Willamette L. Rev. 617 (1993), p. 5.

the other hand, the gracious promises would not be enforced without formality of seal.[10] Such concept brought many inadequacies and therefore doctrine of promissory estoppel was introduced, in which even promises, not fulfilling the required form, could be enforceable, if the promisee had changed his position upon reliance on the promise. Nowadays, as Peter Butt accents, a covenant is effective in practice regardless if it is created by deed or not.[11] Based on the above, it is reasonable to conclude that formality requirement, with respect to covenants, is not anymore a feature distinguishing covenants from other agreements. This is even more obvious in the covenants further analyzed in this thesis, since such covenants almost always have certain consideration.

1.1.1 Business Covenants

In the rest of this thesis, I will focus only on the covenants in debt financing.[12] Here, I will explain what shall be understood under the term "business covenants" which is used by William Bratton in this regard.[13]

The aim of business covenants is a protection of the investors (mainly bondholders, banks or other lenders). Bratton notes that such contractual protection was invoked by the doctrine of corporate fiction and its limited liability and subsequent enactment of rules on capital, starting in New Jersey in 1888 (which authorized low-par and no-par common stock, permitted minimal paid-in capital and later reductions of capital and dropped requirements

[10] *See*, Upham v. Smith, 7 Mass. 265, 266 (1811); A*ccord*, Mitchell v. Kingman, 22 Mass. (5 Pick.) 431, 433 (1827); *but see* Sumner v. Williams, 8 Mass. 162, 186-89 (1811); Pierce v. Woodward, 23 Mass. (6 Pick.) 206 (1828). For more details regarding the formal requirements of covenants and the consideration, *see* Eric Mills Holmes, *supra* note 9, p. 5-6; and Alfred W.B. Simpson, *A History of the Common Law of Contract* (1975), p. 416-52.

[11] Peter Butt, *Land Law* (2d ed. 1988), p. 334. *Cf* "the word covenant strictly means a promise under seal, although it may refer in general parlance to any promise." *David securities Pty & Ors v. Commonwealth Bank of Australia,* (1992) 175 CLR 353 In: Stephen Barkoczy, *Australian Tax Casebook* 145 (10th ed. 2010).

[12] However this is not the only area of law in which we may find covenants. *See e.g.* real estate covenant Weiser Jay, The *Real Estate Covenant as Commons: Incomplete Contract Remedies Over Time* 13 S. Cal. Interdisc. L.J. (2003-2004), p. 269 and covenant not to compete Harlan M. Blake, *Employee Agreements not to Compete*, 73 Harv. L. Rev (1960), p. 625, and Harvey J. Goldschmid, *Antitrust Neglected Stepchild: A Proposal for Dealing with Restrictive Covenants*, 73 Colum. L. Rev. (1973), pp. 1193-1207.

[13] William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 Eur. Bus. Org. L. Rev. (2006), p. 5. Available at SSRN, http://ssrn.com/abstract=902910.

for various financial ratios).[14] The business covenants appeared with debenture indentures on the beginning of previous century and according to Bratton they provided "more flexible security device than the real property." He notes that later they have been used also in other types of debt financing. "The debenture indenture, used for public bond issues, continues to perform its original function in tandem with two close cousins developed later in the twentieth century, the [i] note purchase agreement used in private placements of long-term debt securities and the [ii] term loan agreement used in long-term bank lending mortgage." [15]

Business covenants can be found in various legal documents used in debt financing, by which the investors provide their money to the firm as a debt and anticipate their repayment, namely in the (i) bank loan agreements and (ii) bond and other debt security indentures.[16] The definition, contained in the Model Covenants' Provisions[17], is related only to the bond covenants, but for the purpose of this thesis, it might be also used with respect to the covenants founded in the bank loans. "covenants are the undertakings included in the indentures for debt securities where the investors in the securities are not satisfied to rely only on the issuer's promise to pay the principal of and interest on the securities when due." This Model Covenants' Provisions themselves, support the correlation with loans when after this definition, they add that "[s]imilar to the covenants contained in bank loan agreements, the negotiated covenants protect the investors by limiting the issuer's right to take steps that may

[14] William Bratton, *Id.* note 13, p 5.

[15] William Bratton, *Id.* note 13, p 6.

[16] I understand that there might be some differences between these two groups, however it is not the point of this thesis to distinguish between them or to deal with covenants founded in equity financing, or to deal with so called "exotic securities" which have the features of debt and equity.

[17] As this work describe itself "[t]he publication of model negotiated covenants is an outgrowth of a process that began in 1960 as the Corporate Indenture Project. That project was originated by the Committee on Developments in Business Financing of the Section of Business Law [the "CoD"] with encouragement from the Securities and Exchange Commission and important financial support from the American Bar Foundation [the "ABF"]. The first Model Debenture Indenture Provisions [the "BDIP"] were published in 1965 at the end of the bearer bond era. … Commentaries on the BDIP were published by the ABF in 1971. Those forms, which include some negotiated covenants and commentary on those covenants have provided a drafting standard and authoritative guidance since that time." They were updated twice in 1983 and in 2000. *Model Negotiated Covenants and Related Definitions*, 61/4 Business Lawyer; (2006), pp. 1439-1539. Available at http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=23411776&site=eds-live.

impair its ability to pay."[18] John Paglia, who presented several publications in this area, speaking about covenants in debt contracts, provided simpler definition. "Covenants are restrictions that specify minimum standards for a borrower's future conduct and performance and typically accelerate the maturity of the loan in the event of a violation."[19]

From the terminology perspective, various designations are used to above covenants, depending on the author's view on the issue. [20] The reason is that the system of covenants is complicated and structured, composing of various types of covenants. However, the adjective "business" in this regard, should be only used to distinguish covenants, which aim is to protect the investors in the course of the debt financing, from the covenants used in other legal areas (such as real estate covenants, antitrust covenants). Hereinafter, I will refer to them as to business covenants.[21] The understanding of this term is the broadest, it represents "full set of covenants" to be founded in debt financing and it covers all subcategories of covenants, particularly affirmative and negative covenants, as well as the financial covenants (or debt or balance sheet covenants) which are limited only to some covenants relating to the financial variables included in the balance sheets.

As will be shown in chapter 3, business covenants are common practice also in civil law jurisdictions for protection of the investors. Therefore, before deeper analysis of how particularly covenants protect investors in sections 1.3 and 1.4, I will analyze the concept of covenants in civil law in which the functional principle of covenants is even more decisive.

[18] *Model Negotiated Covenants and Related Definitions, Id.* 17, introduction.

[19] John K. Paglia & Donald J. Mullineaux, *An Empirical Exploration of Financial Covenants in Large Bank Loans*, 1 Banks and Bank Systems (2, 2006), p. 104.

[20] *See e.g.* the following designations of the business covenants: (i) the positive or affirmative covenants by Paglia. John, G. Paglia, *infra* note 79; (ii) the negative or restrictive covenants by Arnold. Jasper H. Arnold III, *infra* note 54; (iii) the financial covenants by. Ron Box, *infra* note 60, or the balance sheet covenants by Demerjian. Peter Demerjian, *Accounting Standards and Debt Covenants...*, (August 2011). Available at: http://ssrn.com/abstract=1892236; (iv) the corporate or business covenants by Bratton. William Bratton, *infra note* 33; (v) the bond covenants by Smith & Warne., Clifford Smith & Jerold Warner, *infra* note 35; (vi) the loan covenants by Zimmerman and Paglia. Charles Zimmerman, *infra* note 53 John Paglia, *infra* note 79. All the aforementioned authors deal to the some extent with the business covenants as are defined in this work, however they may be focusing on different aspect of this topic..

[21] Such designation is used by professor Bratton. *See*, William W. Bratton, *supra* note 13, p 5.

1.2 Civil Law Concept

Covenants in debt contracts have been used in common law for long time.[22] One may reasonably ask what their equivalent under civil law is, since the lenders also may require some protection in similar sense. However, answering this question is complicated, mainly due to the fact that the civil law does not represent one homogenous system, but rather it is a system comprising of more jurisdictions with differences between each other. The purpose of this thesis is not to find precise covenants' equivalents in each major jurisdiction, but I will only point that the covenants are used and that the practice found its own approach.

From the terminological point of view, the civil law countries do not have precise equivalent of this term and as shown below usually they use terms such as "contract", "agreement" "undertaking" or "contractual clauses" as its equivalent. European Union legislation uses the term "covenant" in the following context "[s]ome borrowing agreements incorporate undertakings by the borrower (covenants)…". [23] The French language mutation of this provision reads as follows "[c]ertains accords d'emprunts comportent des engagements de l'emprunteur (*clauses contractuelles*)…", other language mutations use in the same context following equivalents, the German version "*Vertragsklauseln*", the Czech and Slovak version "*dohoda*", the Italian version "*clausole di garanzia*", the Hungarian version "*megállapodásokat*". In another context, this legislation uses the term "breach of a debt covenant". Other language versions use in this context following equivalents, the German version "*Verletzungen von Zahlungsvereinbarungen*", the French version "*manquement à une clause d'un contrat*", the Hungarian version "*kölcsönszerződés megsértése*", the Czech "*porušení …závazků*", the Slovak version "*nedodržania zmlúv o dlhoch*". Although the

[22] For evolution of the business contracts *see* Churchill Rodgers, *The Corporate Trust Indenture Project*, 20 Bus. Law. (1965), pp 551-571.

[23] EU regulation on accounting. OJ L 261, *Regulation (EC) No 1725/2003 adopting certain international accounting standards*, article 65 and article 17 (2012).

translations of EU regulations are many times criticized, the above comparison may guide us in understanding the difficulties in finding the relevant equivalent of the term "covenant".

The bank practice developed another approach. It recognizes this common law concept and takes it over as it is and even does not find terminological equivalent for it but rather uses the term "covenant" itself. [24] The covenants are not civil law concept and one interesting question may arise whether there might be any difficulties in correlation in the context of civil law order which is not adjusted to such foreign concept. In one study, Keesee asks this question. [25] He compares major civil law jurisdictions and with respect to chosen representative jurisdiction, he points out four problems, which may arise in the enforcement of business covenants in the civil law. Firstly, he pointed out that, his civil law jurisdiction, does not recognize the concept of injunctive relief and therefore, if a lender learns about a borrower's intent to breach a covenant, he cannot successfully seek remedy at the court to enjoin the borrower from violation of the covenant. There is an analogical concept of pre-judgment attachment on debtor's assets in case of success in final judgment; however such concept cannot finally enjoin from the violation. Secondly, he mentions high costs related with the pre-judgement attachment due to the limitations on availability of summary proceeding in this regard. Thirdly, in case of a breach of covenant, the lender may claim damages, however, since his civil law jurisdiction does not admit estimate of damages relating to the foreclosure of assets after the debt's acceleration, it might be possible only in expensive court proceedings. Finally, lender may bring the suit only against the borrower, but not against any third party, who may benefit from the covenant's violation, because of the lack of legislation in his jurisdiction on the interference with contractual rights tort. It is obvious that such difficulties do not have to be present in each civil law jurisdiction,

[24] The following German author uses in her whole work regarding loan agreements the term "covenant". Runge, C. Julia, *Covenants in Kreditverträgen*, (1st ed. 2010).

[25] Allen P. K. Keesee, *The Civil Enforcement of Contractual Covenants*, 12 Lawyer of the Americas (2, 1980), pp. 289- 305.

however, in practice and especially in developing countries, one should always pay attention whether the covenants would be effectively enforceable.

German bankers acknowledge that "the concept of covenants comes from the Anglo-American language and means a "contractual agreement by which the borrower undertakes for certain acts or for omission of acts or assures existence of certain facts. In general, we speak about contractual additional or ancillary [*Nebenabreden*] agreements, which are mandatory for the borrower… the covenants were taken from the Anglo-American loan practice and are now adopted by the German loan agreements." [26] Other lawyers from the practice also acknowledge the origin of this term and further justify their usage by the fact that this concept is much more detailed and sophisticated than the contracts usually used by Continental European lawyers due to the "inductive" method of common law (deriving rule from a particular case, instead of applying the rule to a particular case from a general norm).[27] They, however, do not provide more detailed justifications. Based on my historical analysis in the previous section[28] I agree that the inductive method influenced the concept of "covenants". Covenants were not introduced by any statute, but were brought by the practice in particular cases. Although the civil law had its own concept of *cause*, which is similar to the concept of consideration in common law and the formality requirements played also important role[29], it did not developed the system of writs distinguishing between agreements under seal or without such formal requirement. Therefore in traditional civil law the distinguishing between covenants and other agreement was not developed and also nowadays from the formal point of view is not relevant.

[26] Author's unofficial translation from the work of the bank director Ursula Bergermann. Thierhoff et al., *Unternehmens-sanierung* (1st ed. 2012), p. 686.

[27] Wolfgang Weitnaur, *Covenants und AGB-Kontrolle,* 33 ZIP (2005), p. 1443.

[28] *See* page 4 above.

[29] Further for this concept, *see e.g.* Arthur von Mehren, *Civil Law Analogues to Consideration: An Exercise in Comparative Analysis* 72 Harv. L. (April 1959), p. 1009; and for the relation of civil law and covenants *see e.g.* James Gordley, *Louisiana and the Common Law,* 24 Tul. Eur. & Civ. L.F. 191 (2008), p. 2.

The opinion that covenants in the financial sector have a meaning as "additional or ancillary agreements" to the payment conditions is in general accepted. However, Fengler claims that the covenants are somehow more specific and they put stress on the goals to be achieved by the covenants. In this regard, they designate the covenants as the "security in the broadest sense" (*Sicherheit im weiteren Sinne*) or the "substitute security" (*Ersatzsicherheit*).[30] The situation in Slovakia is same. Business covenants, as described in below, are typical part of the loan agreements in Slovakia. In the banking practice, they are designated as (i) additional undertakings, or (ii) particular undertakings, or just simply (iii) undertakings, or (iv) obligations.[31] The distinguishing feature cannot be found in their legal nature, because from the formal point of view, they are in the form of obligations, which cannot be distinguished from any other obligations of the debtor under the loan agreement. Similarly than was stressed by the above German authors, such distinguishing feature is only their protective function, which absent in the other obligations.

To sum up, civil law uses business covenants in practice but it does not recognize differences from other promises based on the form based and rather it pays attention on the functional principle.

[30] Patrick Fengler, *Covenants im Firmenkundenkreditgeschäft der Volks- und Raiffeisenbanken – Eignung und empirische Analyse*, p. 3. Available at http://www.dhbwvs.de/fileadmin/content/01_UEBER_UNS/04_Studienangebot/02_Fakultaet_ Wirtschaft/ Bachelor/Banken_und_Bausparkassen/Schriftenreihe-Dateien/06-08-Covenants.pdf. It shall however be noted that in this regard the term "security" should be interpreted in its broadest sense and not as *in rem* right or *quasi-in rem* right and should not mean a right taken or asset given as a guarantee of the fulfillment of a debtor's obligations, nor a security interest which is registrable.

[31] I have analysed the general terms and conditions for loans of below mentioned major Slovak banks (the "GTC"). The business covenants, as are described in the following chapters, are allocated in particular sections of these GTC. The names of these subchapters are: (i) Undertakings ("*Záväzky*") – Section 8 of the GTC of a bank from the RZB group. Available at: http://www.tatrabanka.sk/cms/att/1431043/VUP_SJ_2008.pdf, (ii) Obligations ("*Povinnosti*") – Section 15 of GTC of a bank from the KBC BANK group. Available at: http://www.csob.sk/Files/Obchodne_podmienky/OP_Uvery_15122011.pdf; (iii) "Additional undertakings" ("*Ďalšie záväzky*") – Section 7 of the GTC of a bank belonging to Erste group. Available at: http://www.slsp.sk/downloads/op_uvery_sme_vns.pdf; and (iv) "Particular undertakings" ("*Osobitné záväzky*") – Section VIII of the GTC of a bank belonging to UniCredit Group. Available at: http://www.unicreditbank.sk/att/101426/OP_uvery-pre-podnikatelov.pdf. The names of the sections were translated by the author.

1.3 *Function of Business Covenants*

As will be described below, the different interests between lenders and borrowers determine the function of the business covenants. Once upon the credit is extended by the lender, the borrower's main expectations have been basically fulfilled, since he received funds which he needed for conducting his business. *Per contra* the expectations of the lender, once he has provided his money, just start since he anticipates the repayment of the principle, together with some interests.[32] Bratton, expert on corporate finance, notes "[lender] must ultimately rely on the borrower's conduct of its business for the fulfillment of [lender's] expectations." [33] He points out that various events may occur on the side of the borrower and its business, either depending on his will or depending on the exogenous market events, which might diminish the borrower's ability to repay. The best solution is to have a full security[34], but on the other hand he states that actually covenants are also an instrument enhancing the lender's position.

In early works on this topic, various authors identify different interests between investors (bondholders and lenders) and the firm (issuers and borrowers) with respect to financing.[35] Smith and Warner call it a bondholder-stockholder conflict in which the maximization of bondholder wealth does not maximize the stockholder wealth and *vise versa*.[36] Four major sources of the conflict between bondholders and stockholders introduced by Smith and Warner have been reproduced also by Fischel with respect to the loan financing (hereinafter: bondholders-stockholders, conflict or investors-stockholders conflict).[37]

[32] This is the same in with bond, when the bondholder anticipates repayment of his investment with some extra surplus.

[33] William W. Bratton, *Corporate Finance*, (5th ed. 2003), p. 209.

[34] Bratton in his works mainly deal with covenants founded in unsecured transactions, but as Grant Gilmore says "A … covenant is a stipulation between a creditor (who is typically unsecured but could perfectly well be secured) and a debtor …". Grant Gilmore, *Security Interest in Personal Property*, (1965), p. 1000.

[35] *See generally*: Clifford W.Smith & Jerold B. Warner, *An Analysis of Bond Covenant*, 7 J. Finan. Econ. (1979) pp. 118-119. *Accord* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure*, 3 J. Fin. Econ. (1976) p. 305, S. Myers, *Determinants of Corporate Borrowing*, 5 J. Fin. Econ. (1977) p. 147.

[36] Clifford Smith & Jerold Warner, *Idem* 35, p. 118.

[37] Daniel R. Fischel, *The Economics of Lender Liability*, 99/1 Yale L.J., (Oct., 1989), pp. 131-154.

First source - *the dividend payment*.[38] The bonds are issued based on certain dividend policy, if however this is changed and the dividends are raised, the value of the bonds is reduced. Ultimately, "if the firm sells all its assets and pays a liquidating dividend to the stockholders, the bondholders are left with worthless claims."[39] Professor Fischel with respect to loan financing notes "[o]nce a lender contributes to a firm, the borrower has an incentive to withdraw assets from the firm by, for example, declaring a dividend for the amount of the loan." [40] It shall be added that in this regards, not only the dividends are relevant, but also other means which has the same effect, such as dividends, spin-offs, stock repurchases, stock redemptions.

Second source - *claim dilution.*[41] The bonds are issued based on the assumption that no further debt shall be issued. Yet by issuing additional debt, the value of bonds is also diminished. With respect to loans was noted that "a borrower can reduce the value of outstanding debt by issuing more debt and thereby diluting the claims of existing creditors."[42]

Third source - *asset substitution*. The bonds are issued based on the specific purpose of engaging in projects with certain risk level and the value of the bond is corresponded to such level. Its value however decreases in case of substituting the projects with different (higher) risk. Professor Fischel stress out in this regard that in case the borrower does not use

[38] Example. "Assume now that Firm A, with assets worth 100 and debt claims of 85, owns asset x, valued at 10. Firm A sells x to Firm B for 10 in cash, and then declares and distributes to its shareholders a dividend of 10. Because Firm A retains a net worth of 5 (and remains solvent on a going concern basis), the dividend is not a fraudulent conveyance. This asset withdrawal26 nonetheless materially injures the interests of Lenders 1 and 2 by reducing Firm A's net worth from 15 to 5. A covenant that blocks the sale of asset x would enhance the positions of Lenders 1 and 2. But it would not protect them from all forms of asset withdrawal. Firm A might in the alternative liquidate an asset over time, directing the proceeds to its shareholders as received. Accordingly, Lenders 1 and 2 also need a covenant that prevents Firm A from transferring assets to its shareholders, by dividend or otherwise." William W. Bratton, *infra* note 47, p. 7.

[39] Clifford Smith & Jerold Warner, s*upra* note 35, p. 118.

[40] Daniel R. Fischel, s*upra* note 37, p. 134,135.

[41] Example. "Assume that Firm A is worth 100 and has borrowed 50 from Lender 1 pursuant to an unsecured loan. The loan was priced on the assumption of no further borrowing by Firm A but contains no explicit restrictions. Firm A then borrows 35 from Lender 2 and invests the proceeds in a project that turns out to be worthless. Firm A emerges 85 percent levered. The interest rate on the second borrowing will reflect that possibility, compensating Lender 2, while the interest rate on the first borrowing does not compensate Lender 1. Lender 1's investment declines in value, with the benefits of the decrease accruing to Firm A and Lender 2. Lender 1 is even worse off if Lender 2 makes a loan secured by assets worth 35. So long as the obligation to Lender 2 remains outstanding, the encumbered assets will not be available to satisfy Lender 1. Accordingly, Lender 1 must look for repayment to an asset base of 65 rather than the base of 100 envisaged at the time of the loan." William W. Bratton, *infra* 47, p. 6.

[42] *Idem* 40, p. 6.

his own money, there will be higher chance of investment in riskier projects and in the extreme cases when there will be limited amount of borrower's equity, the firm has almost nothing to loose. On the other hand in case of success of such projects, the lender does not share extra profits. "[B]efore the loan is made, the borrower bore the costs of risky investments that failed; now [after the loan is made] these costs are shared with the lender. Before and after the extention of credit, however, the borrower alone obtains the benefit from risky investments that succeed." [43]

Fourth source – *underinvestment.* The underinvestment may occur in case the major firm's income accrues the bondholders. As a consequence, the firm may avoid investing in the new projects and as such, the value of the bonds also depreciate. The "additional claim [on the firm's income stream created by the debt] can result in the borrower failing to invest in a profitable investment project if too much of the benefit from the project will accrue to the lender." [44]

Bratton claims in his analysis of the Fischel's example[45] that the lenders, in the aforementioned sources of investors-stockholders conflict, seek protection in the "borrower's equity cushion" and further he claims that actually the covenants are the instruments which shall "keep the equity cushion in place and make it available to generate payments on the loan." [46] Based on this, the function of the business covenants is the protection of the

[43] *Idem* 40, p. 6.

[44] *Idem* 40, p. 7.

[45] "Consider a hypothetical company with capital of $200, consisting of equal $100 contributions of debt and equity. Now assume that the company suffers a $100 decline in value as a result of a recession. The remaining $100 of value is just enough to pay off the lender. Although debtor misbehavior did not cause the $100 decline in value, this decline will have a profound effect on the borrower's incentives. … the borrower's incentive to invest in risky projects increases as the value of the debt falls, because the borrower now has less of its own funds at risk. … the borrower would not have been likely to have accepted a project with a negative net present value of less than $100 when the firm was worth $200 because the borrower would bear the loss. However, once the value of the firm has fallen to $100, the borrower might be willing to invest in a project with some upside potential even if its expected value is negative because the loss is borne by the lender. Furthermore, if the value of the firm falls below $100, the borrower may even reject some positive net present value projects due to the underinvestment problem. Because the benefits of the investment in this situation go to the lender, the borrower has no incentive to proceed. … The lower the equity cusion, the greater the probability that these actions will harm existing creditors." Daniel R. Fischel In: William W. Bratton, *Corporate Finance*, p. 211 (5th ed. 2003).

[46] William W. Bratton, *supra* note 33, p. 212.

creditors through assurance that the firm will have sufficient value available for creditors.[47] Therefore, a classification of the covenants as quasi-securities or so creditors' position enhancing devices, is deemed to be relevant.[48]

Additionally, according to the various economic studies, the firm itself also benefits from the business covenants.[49] It is acknowledged that despite the fact that high costs (mainly comprising of the negotiation and monitoring costs) are related with the business covenants, the firm may get better financial terms and conditions of the loan or bond than it would get in the loan or bond without any covenants included. In newer economic study[50], Bradley and Roberts denote the conflict between bondholders and stockholders as "agency theory of covenants" and they with respect to these better financial terms and conditions further state that the rational bondholders anticipate such conflicts and value the costs of the bonds accordingly.[51] These costs are borne by the stockholders, who in order to minimize such costs, incorporate the covenants in the indentures. The covenants represent the voluntary constrains ordering or restricting the firm from certain actions in order to prevent the bondholders-stockholders conflict. Consequently, the bondholders shall be willing to include better terms of the bonds (better interests, repayment schedule *etc*.) in case the bonds include protective covenants.[52]

[47] In this regard, Bratton in another work compares the continental Europe system, in which the statutory acts shall protect the creditors, with the US system, in which the contractual protection of creditors prevail. William Bratton, supra note 13. *See generally* Luca Enriques, Jonathan Macey, *Creditor versus Capital Formation: the Case against the European Legal Capital Rules*, 86 Cornell L. Rev. 1165 (Sept. 2001).

[48] *See generally*: Martijin van Empel, *Financial Services in Europe*, (1st ed. 2008), p. 167. This author uses such designation.

[49] "Financial contracting is assumed to be costly. However, bond covenants, even if they involve costs, can increase the value of the firm at the time bonds are issued by reducing the opportunity loss which results when stockholders of a levered firm follow a policy which does not maximize the value of the firm. Furthermore, in case of the claim dilution problem, if covenants lower the costs which bondholders incur in monitoring stockholders, the cost-reducing benefits of the covenants accrue to the firm's owners." Clifford W.Smith & Jerold B. Warner, *supra* note 35, p. 121.

[50] Michael Bradley & Michael R. Roberts, *The Structure and Pricing of Corporate Debt Covenants*, (May, 2004). Available at SSRN: http://ssrn.com/abstract=466240.

[51] For instance, consider the loan contract without any restrictive covenants, nor security. Typically, the lenders would be willing to provide money only with high interest rates, because such loan would be risky. However, if the lender gets some assurances in the form of covenant, he would be satisfied with lower interest rates, because the investment is less risky.

[52] Many economic studies examining various aspects of the bondholders-stockholders conflict have been introduced. *See e.g.* the study (i) on the firm's optimal choice between harsh covenants that might prevent good projects and lenient covenants allowing bad projects in relation to the monitoring of the covenants. Mitchel Berlin & Jan Loeys, *Bond Covenants and*

1.3.1 Objectives of Covenants

Legal practitioners, such as Zimmerman, recommend that following issues should be covered in the drafting of the business covenants: [53]

Full disclosure of information. The lender must be ensured that he has all necessary information about the borrower, not only at the time of the signing of the relevant loan agreement, but also during the life of the loan. Therefore, he must be informed about all events that might have impact on the loan repayment (*e.g.* any pending law proceedings), he must receive annual financial statements and other information which are available to the stockholders of the borrower.

Preservation of the net worth. As was described above, the creditors rely on the value of the firm when all its debts would have been repaid. As it was noted, the net worth identifies the strength of the firm and it shall be on sufficient level in order to prevent an excessive leveraging and financing through short term loans.[54]

Maintenance of asset quality. The above recommendations claim that assets value plays important role as earning power and liquidation value. If the assets are of low quality, there is a presumption that the debt will not be repaid. Alike, the assets represent an ultimate source of repayment in the course of the liquidation and if they are of miserable quality, then the creditor will not be satisfied. The quality in this regard, is not related only to the physical features of the assets (*e.g.* that the assets shall be in sound and operative state, or that certain assets cannot be transferred or transferred only for reasonable price), but also to legal features (*e.g.* that the assets shall not be subject to any further pledge, or that they shall be insured).

Delegated Monitoring, 43/2 J. Finance (June, 1988), pp. 397 – 412; (ii) on the determinant of the lender and borrower characteristics such as size, risk industry as well as macroeconomics factors on the structure of the covenants with the possible consequence that if the borrower's business is more risky, the more restrictive or nonstandard the covenants will be. Michael Bradley & Michael R. Roberts, *supra* note 50; (iii) in which authors found that "riskier firms and firms with fewer investment opportunities select tighter financial covenants." Demiroglu Cem & James Christopher, *The Information Content of Bank Loan Covenants* (March, 2010), p. 1. Available http://dx.doi.org/10.2139/ssrn.959393. (iv) in which authors found that "covenant protection is increasing in growth opportunities, debt maturity, and leverage". Matthew Billett et al. *Growth Opportunities and the Choice of Leverage, Debt Maturity, and Covenants*, 62 J. Finance (April 2007), p. 697.

[53] Charles S. Zimmerman, *An approach in Writing Loan Agreement Covenants*, RMA Journal (May 2007) p. 64. *Cf.* Philip Wood, *infra* note 72, 8-02 – 8-04; Particular objectives will be described with respect to each covenant in section 2.2 below.

[54] Jasper H. Arnold, *How to Negotiate a Tem Loan*, Harvard Bus. Rev. (March 1982) p. 133.

Maintenance of the adequate cash flow. In the ordinary course of loan life, the loan is repaid from the cash flow of the borrower and therefore the lender's interest is assurance of adequate level of the cash flow.

Control of growth. Notwithstanding that the growth of a firm is important, because only healthy and prospering firm can repay its loan, if the growth is unlimited, the borrower may carry out risky transactions which may have negative effects on the loan. Therefore there should be clear limits on the investments by the borrower.[55]

Control of management. To the some extent, the covenants need to limit acts of the management. In this regard they not only set obligations for the management, but also give some powers to the lenders to influence the composition of the management.

Assurance of legal existence and concept of going concern. The lender shall protect himself against challenges of the firm's existence as an entity which is responsible for the repayment of the debt (sales of assets, change of the ownership *etc*.).

As was shown above, the function of covenants is to moderate the investors-stockholders conflict by setting contractual rules to be followed during the course of the loan life. Notwithstanding that they enhance the position of lenders, they cannot assure the repayment of the loan. Such assurance might be partially achieved by providing of full security. What is the source of enhancement then, that the covenants bring, will be discussed in the next section regarding consequences of business covenants' violation.

1.4 Consequences of Business Covenants' Violations

As discussed above, the covenants are of contractual nature and as such represent legally binding promises. Such promises, however, cannot guarantee the repayment of the loan, neither procure direct full satisfaction of the lender's claim. If the covenant is breached

[55] According to the professor Arnold, such limitations are: (i) reduce the total amount of money invested in a particular product market, (ii) spread the investment out over a longer time period by (a) limiting capital expenditures and acquisitions, or (b) by writing in a debt-to-equity test. *Idem* p. 133.

or is about to be breached, the lenders have option of calling a default and accelerating the loan. Bratton also acknowledges that this option does not assure payment either, but on the other hand it has still some value.[56] He claims that the borrower in default can either (i) cure the default, (ii) offer lender a substitute performance for the waiver, or (iii) seek the protection of a bankruptcy proceeding.

Acceleration of the loan, when all claims of the lender become due, usually leads into the bankruptcy of the borrower, particularly in case the borrower already has some difficulties. Naturally, the borrower is reluctant to be declared bankrupt unless he is in extreme distress, because in bankruptcy all stockholders' claims are in general satisfied only after satisfaction of all other creditors[57]. Additionally, the acceleration and the breach of the covenants may also trigger other security devices in the loan agreement such as collateral foreclosure or bank guarantees, provided that the loan is secured. Therefore, the borrower may not find the *latter* option of acceleration and subsequent bankruptcy as adequate and he will opt to do everything for first two options. In the *first* option, in which the default is cured, both parties are satisfied and the threat of accelerating of loan due to breach of covenants, solves the problem itself. In the *second* option, due to the threat of acceleration, the borrower re-negotiates contract with the lender as a *quid pro quo* for not accelerating the loan. Consequently, the lender gets better terms and conditions of the loan (better interest, one-off fee, another collateral *etc*.) than in the original contract prior to the violation of covenants and because of the existence of covenants, the lender is better off in the loan enforcement. Without covenant, the lender cannot force the borrower to such measures. Even

[56] William Bratton, *infra* note 33, p. 210.

[57] As was stated previously, the covenants (i) provide sufficient level of equity cushion of borrower's stockholders through restrictions on asset withdrawal and claim dilution, and (ii) otherwise ensure the value of the firm. In this section, I discuss situations when the borrower is willing to deal with the problem outside of the bankruptcy, because the firm has still some value for his stockholders, which might be otherwise lost in the bankruptcy. However, if the borrower is in serious difficulties, he may find more effective to seek protection against its creditors in bankruptcy or in reorganization, in which only full security can protect the creditors. *See*, a study in which authors found that "among violations reported by the firms, a waiver is more likely to be granted to a firm with a lower estimated probability of bankruptcy and a lower leverage ratio. In addition, secured or small debt issues have a better chance of receiving violation." Kevin Chen & John Wei, *Creditors' Decisions to Waive Violations of Accounting-Based Debt*, 88 Acc. R. (April, 1993), p. 230.

in the case of bankruptcy, the lender with good drafted covenants may learn about the adverse situation earlier and may carry out all necessary steps preventing additional negative effects.

The question may arise whether the lender has a possibility to accelerate the loan upon his sole discretion without limitation. The common law answers this in lender's favor. "[A] lender with a right to accelerate may accelerate the borrower's obligations as she wishes and so may demand payment immediately, without giving the borrower any grace period nor time to find the money…, if the term in the contract permitted recovery on that basis."[58] In this regard it might be advisable that the borrower specifies conditions upon which the loan may be accelerated (such as grace period, notice delivery, materiality *etc.*). However, if the contract is silent; the lender does not have such a right.[59]

It seems that the lender's position is extremely superior and if a covenant is breached or about to be breached, the borrower may await difficulties from the lender's side. However, from the business perspective, it is not the lender's incentive to get the borrower into bankruptcy by accelerating the loan because such borrower cannot ask for a new loan in feature.[60] Further reasons why the lenders seldom force their borrowers into bankruptcy are that in bankruptcy their claims are usually not fully satisfied (unless secured by substantive collateral) and additionally such proceeding incurs high legal costs, it is time consuming and brings negative publicity. With respect to the role of acceleration in loan agreements, it is noted that "more than facilitating collection, acceleration's prime role is to enhance a creditor's control and governance. Acceleration complements the contractual covenants and

[58] Alastair Hudson, *The Law of Finance*, (2009), p. 876. *See also* the case *Brightly v. Norton* which states that "a debtor who is required to pay money on demand, or at a stated time, must have it ready, and is not entitled to further time in order to look for it." *Brightly v. Norton* (1862) 122 E.R. 118.

[59] In *Williams & Glyn's Bank v. Barnes*, it was decided that the provision "usual banking conditions" cannot be interpreted that the bank is entitled to ask for advance repayment in case it was agreed that a loan facility would be available for specific period of time, unless specifically stipulated in the contract otherwise. *Williams & Glyn's Bank v. Barnes*. Available at Legal Decisions Affecting Bankers (1981) Com. 205. *Accord: Cryne v. Barclays Bank*, (1987) B.C.L.C. 548.

[60] "The bank will expect to include covenants that protect its interests. However, bear in mind that banks want your business to succeed. They prefer to help businesses grow so that their risks remain low and more loans are requested from the banks." Ron Box, *How to Effectively Negotiaite Loan Covenants*, J. Acc. (August 2010) p. 1. Further on the issue how much benefits can lender get from the acceleration *see generally* Hahn, David, *infra* note 61.

serves as the ultimate stick over the heads of the disciplined constituencies." [61]

In one interview by Ferrence, bank's senior president, points out that many difficulties could be avoided by the mere communication with the bank.[62] "Nobody likes surprises. Many typical loan covenant violations happen when a client asks for a waiver for something that could have been brought to the bank's attention prior to the actual event occurring." The banker gives an example, in which the covenant limits expenditures to no more than $250,000, but client purchased for $500,000. This is an obvious breach of such covenant. However, as he notes, if the client communicates with the bank and explains the reason, he may even get a credit for such purchase or at least prior written consent with such action. He stress out that the covenant's violation does not automatically mean acceleration of the loan, if the bank sees "the reasoning behind and plan to cure the violation". Even, if the violation is non-curable, the client could get "some type of a fee or a possible restructuring". On the other hand, even though the acceleration of the loan is rarely used in the event of covenant's violation and the loan re-negotiation or option to cure the default usually follows, as Grant Gilmore said fifty years ago and it is true also nowadays "[f]or a hundred years … no security agreement has failed to include an acceleration clause."[63]

Without an acceleration clause, a breach of a covenant would be hardly enforceable[64] and the negotiation position of the lender would be weak. Therefore, the lenders typically insist on the acceleration clause which improves their negotiation position in case of difficulties with the loan which are to be covered by the covenants. If the lender does not have an option to accelerate the loan or otherwise sanction the borrower after the covenant is breached, the system of business covenants would not be effective.

[61] David Hahn, *infra* note *60,* p. 3.

[62] Gregory A. Ferrence, *Keeping the faith*, Smart Business Cleveland, (July 2009) p. 78. *Accord* Ron Box, *supra* 60, p. 2.

[63] Grant Gilmore, *supra* p. 1195.

[64] The statutory right to terminate the loan might be also much more difficult to enforce than the right directly expressed in the contract. Claiming the damages due to the covenant's breach is problematic, since the actual damage would be difficult to prove and usually would be unforeseeable. Other types of damages, such as liquidated damages, might be applicable.

CHAPTER 2 – SYSTEM OF BUSINESS COVENANTS

The standard loan agreement or bond indenture includes many various business covenants. The reason for this stems from the various ways in which the stockholders-investors conflict could be realized. Together all covenants create a complicated system, which I will describe in this chapter in order to show the practice developed under common law which I will compare with practice in Slovakia in chapter 3.

There are many determinants which may influence the actual business covenants in particular cases. These include for instance, whether a debt is secured or not, what kind of risk is related with a debtor's business, what is the debt's maturity, what are the growth opportunities of the debtor's business, on what is leverage level, what is the firm's bargaining power and what is the current state of the market.[65] The general rule is that more risky a debt is, more strict the covenants are. With respect to the wording of the covenants, the standardized boilerplates are used. Smith and Werner justify it by the reducing of the costs of covenants' negotiating, monitoring and their enforcement.[66] However, sometimes covenants, especially financial covenants in which precise numbers are important, must be tailor made, in order to give them effect. These standardized clauses are provided for example by the Model Covenant's Provisions[67] prepared by American Bar Foundation with respect to bond issues and Financial Covenants Provisions and other loan guides prepared by Loan Market Association and major law firms with respect to loans.[68]

[65] *See* note 52 *supra*.

[66] Clifford Smith & Jerold Warner, *infra* 35, p. 123; *Cf.* "Successor obligor clauses are "boilerplate" or contractual provisions which are standard in a certain genre of contracts. Successor obligor clauses are thus found in virtually all indentures. Such boilerplate must be distinguished from contractual provisions which are peculiar to a particular indenture and must be given a consistent, uniform interpretation." *Sharon Steel v. Chase Manhattan Bank* 691 F.2d 1039,1982 U.S. App.

[67] *Model Negotiated Covenants and Related Definitions*, *supra* note 17.

[68] Loan Marker Association, *Financial Covenants Provisions* (2006),. Available at: http://www.loan-market-assoc.com; and Slaughter and May, *The ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers*, (February 2010). Available at: http://www.treasurers.org/loandocumentation/investmentgrade; or Slaughter and May, *The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions* (Sept. 2008). Available at. http://www.treasurers.org/loandocumentation/leveraged; Krass Monroe, P.A., *Loan Documentation: An Introduction for Small Businesses*. Available at http://www.positivelyminnesota.com/Data_Publications/Publications/All_Other_DEED_Publications/Loan_Documentation_-_An_Introduction_for_Small_Businesses.aspx.

2.1 Classifications of Business Covenants

Before presenting particular covenants, I will outline various classifications by different authors in order to show how many different approaches exist.

Firstly, David Hahn divides covenants in following groups: (i) "*payout covenants"* – limiting "the borrower's ability to initiate distributions to its shareholders, either by formally announced dividends, spin-offs, stock repurchases, stock redemptions or otherwise;" (ii) "*capital structure covenants"* - restricting "debtor's freedom to finance its business through relatively risky capital structures;" (iii) "*asset substitution covenants"* – limiting "the firm from engaging in various transactions that may result in substitution of high risk and volatile assets for solid and low risk assets;" and (iv) and "*event risk covenants"* – regulating "acquisition of a certain percentage of the debtor's shares, by a third party, a merger or consolidation, a change in the composition of the board of directors, or a repurchase by the [own] ... shares."[69] This classification is correlated with four sources of the stockholder – investor conflict discussed previously. This author does not provide concrete examples in his classifications and as such it cannot be used for comparison with covenants used in Slovakia.

Secondly, Smith and Warner provide more detailed classification of bond covenants which may be summarized as follows: (I) "*restricting the firm's production or investment policy"*, namely restrictions on/ covenants on (i) investments into another business enterprise, (ii) the disposition of assets substantially as an entirety', or only in the ordinary course of business, or only up to a fixed money amount, or other similar restrictions, (iii) the disposition with pledged assets (when investor is the pledgee), (iv) mergers as a flat prohibition or only upon meeting certain criterions, (v) "requiring the maintenance of assets" (obligations to invest in certain projects, hold particular assets, maintain working capital on certain level), and (vi) "indirectly restricting production or investment policy" (for example

[69] David Hahn, *supra* note *61*, p. 6,7.

failure to accept a positive net present value project); (II) *"restricting the payment of dividends"*, (III) *"restricting subsequent financing policy"*, namely (i) limitations creation additional claims with direct superior priority unless the existing debt is upgraded to have equal priority, or unless certain criterions are fulfilled, and (ii) restrictions of other claims which may have superior position than the claims of the investor namely rentals, lease, and sale-leasebacks; (IV) *"modifying the pattern of payoffs to bondholders"* under which they understand covenants variously controlling bondholders-stockholders conflict, namely (i) sinking fund - which ultimately makes that the bond itself is repaid in installments, (ii) convertibility – which enables to covert bond into other securities (mainly equity), and (iii) callability – which enables to redeem the bond before it is due at agreed price; and (V) "*specifying bonding activities by the firm"* which are called monitoring or information covenants by other authors, namely (i) covenants to supply financial and other information such as financial statements, reports, and proxy statements and other documents which the firm sends to its shareholders, reports filed with government agencies, (ii) covenants dictating specific accounting techniques such as GAAP, (iii) covenant obliging issuance of certificate of compliance regularly by officers that there is no default.[70] This classification comparing the Hahn's work includes the examples of particular covenants, however it is merely focused on bond covenants and therefore implies issues which are not typically relevant in loan agreements which will be analyzed below.

Thirdly, Bratton's view is interesting in that way that he recognizes the traditional classification on *affirmative* covenants (such as borrower's promise to make periodic informational reports, to maintain its franchises, to insure and maintain its properties, and to pay all properly assessed taxes) and on *negative* covenants.[71] He claims that the former goes

[70] Clifford Smith & Jerold Warner, *infra* note 35, p. 125-146. Krass Monroe, P.A. , *supra* 68.

[71] William Bratton, *supra* note 13, p. 9. The traditional distinction of covenants on affirmative and negative covenants was discussed previously. *See* note 7 *supra*.

only to ministerial matters and the latter plays main role in protecting from claim dilution, asset withdrawal, underinvestment, and asset substitution (*i.e.* the sources of stockholders-investor conflict). He finds the reason in the effective control over the borrower and the limited liability. If a lender's power over a borrower through covenants exceeds certain level, he may be declared to have effective control over the borrower and he may be held liable. The negative promises such as not to borrow, pay dividends, or sell assets, are more difficult to prove to have an effective control than the affirmative promises.[72] Therefore his classification of covenants is merely based on negative covenants, which are however similar than the above classifications. His classification is following: (i) restrictions on debt, (ii) restrictions on prior claims, (iii) restrictions on dividends and other payments to shareholders, (iv) restrictions on investments, (v) restrictions on mergers and sales of assets. Furthermore, he mentions early warning covenants[73] which are based on the financial covenants described below.[74] On the other hand Bratton also does not provide examples of particular covenants, which is necessary for this thesis.

Fourthly, English authors, such as Alastair Hudson, deal with business covenants in a quite broader sense.[75] As following classification shows, they include obligations which are not generally mentioned by other authors as covenants[76]: (i) "*covenants as to the condition of the borrower"* – including mainly financial covenants on cash flow maintenance and minimum net worth, covenants that are breached, if the bankruptcy or reorganization is declared (similar like *ipso facto* clauses in US bankruptcy law), prohibitions of restructuring and information covenants; (ii) "*covenants as to the borrower's performance*"– such as covenant to comply with

[72] *Cf.* "a bank which controls and directs management of the company may become a de facto director and be liable accordingly... It is generally true that only in the case of exceptionally intrustive interference in management could a bank be a "shadow director" [recklessly incurring debt] and the mere monitoring of normal covenants will not be enough. The problem tends to arise only in default negotiations of a bank effectively takes over the management, and instructs as opposed to setting out the terms on which it is prepared to continue the facility." Philip Wood, *Law and Practice of International Finance* (3rd ed. 2008), 8-06.

[73] The role of early warning covenants (e.g. if the minimum worth drops below agreed level) is to warn the lender that the firm may be in troubles, so it may conduct all relevant acts which he may find necessary.

[74] William Bratton, *supra* note 13, p. 9.

[75] Alastair Hudson, *supra* note 58 pp. 869-881.

[76] It is not the purpose of this thesis to specifically dedicate to such differences. Pointing out this classification should only show how broadly some authors understand business covenants.

obligations under the contract (mainly obligation to duly pay interest and principal) as well as to comply with any other "credit support agreement" such as collateral agreement, breach of which causes cross-default; (iii) "*covenants as to the continued feasibility of the loan"* – covenants that are breached in case of supervening illegality or substantive change in law[77]; and (iv) "*negative pledge"* and (v) "*parri passu"* clause.[78]

Finally, Paglia in analyzing other work provides the most extensive classification.[79] In his study on frequency of particular covenants in bank loans, he divided covenants in nine following categories: (i) o*perating activity covenants*[80] - "covenants that restrict, in some fashion, the daily operations of the firm;" (ii) i*nvestment expenditure covenants*[81] – "covenants that generally restrict capital expenditures, acquisitions, or other cash outlays;" (iii) a*sset sale covenants*[82] – "covenants that limit, to some extent, the ability of the firm to dispose of assets during the course of business;" (iv) *cash payout covenants*[83] – "covenants that restrict transfers of wealth among the firm's claimants;" (v) *financing* [sic] *covenants*[84]- "covenants that provide limitations on debt, on debt-like contracts such as leases, or on changes in capital structure;" (vi) *reporting and disclosure covenants*[85] - "affirmative covenants that specify some minimum standard of conduct

[77] The covenants which he mentions under point (ii) and (iii), are usually identified by other authors, however in analysis of the particular agreements below, I also identify such provisions in the loan agreements. They however were not typically included in the sections which dealt with covenants.

[78] Alastair Hudson, *supra* note 58 pp. 869-881.

[79] Johna Paglia, *An Overview of Covenants Large in Commercial Bank Loans*, The RMA Journal (Sept. 2007), pp. 75-77. Paglia analysis is based on the Gilson and Warner work. Gilson, Stuart. & Warner, Jerold. *Private versus Public Debt: Evidence from Firms That Replace Bank Loans with Junk Bonds*, 1998 Available at:, http://ssrn.com/abstract=140093.

[80] Such as covenant to (i) preserve existence of company status and line of business, (ii) pay taxes and comply with all contractual and statutory obligations, (iii) restrict use of proceeds (iv) enter into interest rate swap or hedge (v) omit entering into material contracts (vi) comply with laws and regulations (vii) manage retirement plans with employment pension standards, (viii) restrict transactions with subsidiaries and affiliates.

[81] Such as (i) restrictions of capital expenditures, (ii) limitation of expenditures to certain dollar level, (iii) restriction on investment into subsidiary, (iv) restriction of acquisitions.

[82] Such as (i) restrictions of divestitures and business units, (ii) restrictions on voluntary liquidation, (iii) restrictions on asset transfers, (iv) sale of assets only in ordinary course of business, or in basket provided.

[83] Such as (i) dividend restrictions and other restricted payments, (ii) restrictions on stock repurchases and stock redemptions, (iii) restriction on loan prepayment and prepayment of subordinated debt, (iv) restrictions of management salary.

[84] Such as restrictions on (i) ability to provide loans to subsidiaries, (ii) ability to provide guarantees, (iii) leases, (iv) sale-leasebacks, (v) change in capital structure, (vi) change in capital stock, (vii) availability to provide financing to suppliers, (viii) on new equity issues.

[85] Such as covenants to (i) keep proper books and records, (ii) permit lender's inspection books and properties, (iii) permit interviewing of management by lender, (iv) furnish lender with financial statements and other documents, (v) keep the accountancy method, (vi) provide certificate of compliance, (vii) notify lender about material adverse change, pending litigations and default with loan covenants.

for dissemination of information;" (vii) *preservation-of-collateral and seniority covenants*[86] - "restrictions that increase the likelihood of payment in the event of default by limiting the erosion of collateral liquidation values;" (viii) *management, control, and ownership covenants*[87]- covenants that restrict the governance structure of the firm, and (ix) *financial covenant types*[88] - "restrictions based on specific balance sheet, income statement, or cash flow items, [t]his type of covenant is directly measurable and verifiable", this category he further divides on financial covenants limiting (a) liquidity, (b) equity, (c) debt and leverage, (d) coverage and cash flow, (e) investment, and (f) dividend and distribution.[89] The main benefit of his work for my thesis is not only the numbers showing which covenant is the most frequently used in US loans but the fact that he provided examples of such covenants.

The above shows that among scholars there is no uniform approach as to the classifications of covenants. They use various criterions in dividing covenants and even some authors add certain types of covenants which are not mentioned by others. Therefore in the next section I will combine their classifications, however I will come out from the Paglia's work.

2.2 Standard set of covenants

For the purposes of chapter 3, the typical wording of the particular covenants[90] will be needed. Only with wording of the particular covenants, I can seek relevant provision in Slovak legal documents. Although Paglia gives the examples of covenants, he does not provide their particular wording. Therefore in this section, I will examine the recommended standard provisions and allocate them to the examples of covenants provided by Paglia. I will use traditional classification on (i) affirmative covenants, (ii) negative covenants, (iii) and

[86] Such as covenant to (i) increase collateral in case of default by borrower or its subsidiary, (ii) maintain valid all security agreements and guarantees, (iii) restrict guaranteeing debt, (iv) maintain value of properties and collateral at certain level, (v) purchase insurance, (vi) maintain guarantee, (vii) not to agree on limitation of ability to provide future security.

[87] Such as restrictions on (i) management and board changes, (ii) restriction on current stock ownership and hostile takeovers, (iii) mergers, acquisitions and consolidations, (iv) creation of new classes of stocks and stock splits.

[88] Examples are provided in below chapter 2.2.3.

[89] John Paglia, *Id.*, 79, p. 75-77.

[90] Which are according to Paglia's study usually found in the loan agreements in US.

financial covenants[91] and I will explain their function. I will not focus on all Paglia's covenants but only on those with frequency of their occurrence at least 20 % in his loan sample (hereinafter the "covenants frequency") and which are generally commented by model provisions[92]. This part has more descriptive nature, however in each example I will evaluate the function of the covenant in line with the analysis in section 1.3 above.

2.2.1 Affirmative covenants

As defined previously, affirmative covenant require some action from the borrower. The following list is aligned according to the covenants frequency.

Reporting, Disclosure or Information covenants- The covenant frequency is 95% with respect to furnishing of financial statements and other financial documents, 72% with respect to obligation to keep proper records, 75% with respect to lender's right to inspect books and properties, and 31% with respect to obligation to keep certain accountancy method. The function of this covenant is to keep the lender updated and informed about the status of the borrower and his business and to allow him to monitor the compliance with the covenants.[93]

> "Borrower shall at all times maintain accurate and complete books and records and copies of all material agreements to which it or the Collateral is a party or is bound. Lender may inspect and make copies of those books and records and any other data relating to Borrower or the Collateral at reasonable times. Borrower shall deliver or cause to be delivered to Lender the following: [Management prepared certified quarterly financial statements], [Annual financial statements… prepared by an independent certified public accountant], [a business plan and projected financial statement for new fiscal year], [other information and data as Lender may from time to time reasonably request]." [94] The model provisions also provides with respect to each document also timing in which relevant document should be delivered.

Insurance - The covenant's frequency is 91 %. The function of this covenant is to maintain the value of the borrower's firm in case of an unforeseeable event which is covered

[91] Paglia refers also in his work on this traditional classification. Paglia, *supra* note 79, p. 75.

[92] *See* note 67 and 68 *supra*. However the main source of the clauses will be examples provided by the law firm Krass Monroe. Krass Monroe, P.A. *supra* note 67.

[93] Wood calls such covenants "information covenants". Philip Wood, *supra* note 72, 8-07.

[94] Krass Monroe, P.A, *supra* note 68, p. 25,26.

by an insurance policy. According to the LMA guide, this covenant usually requires to contract the insurance with a reputable independent insurance company, the covenant also determines the risks which the insurance policy should cover and the extent which should be usual for companies conducting similar businesses.[95]

> "Borrower shall maintain such policies of insurance with reputable insurance carriers as is normally carried by companies engaged in similar businesses and owning similar property, and name the Lender as loss payee on all policies insuring real or personal property in which Lender has a security interest and provide Lender with certificates of insurance evidencing its status as a loss payee." [96]

Maintenance of Corporate Existence – The covenants frequency is 86 % (it is however examined only with preservation of line of business covenant below). The function of this covenant is to prevent changing the corporate structure or dissolving in order to avoid loan repayment without leaving any assets available for the lender. The wording stipulate in various manner borrower's obligation to maintain its legal status as a business entity (usually in the form of a corporation).

> "For so long as any Obligations shall remain outstanding, Borrower shall preserve and maintain, and cause each subsidiary to preserve and maintain, its corporate existence in good standing in its state of incorporation and qualify and remain qualified, and cause each subsidiary to qualify and remain qualified, as a foreign corporation in each jurisdiction in which such qualification is necessary." [97]

Preservation of Line of Business- The covenants frequency is 86 % (it is however examined only with maintenance of corporate existence above). The function of this covenant is to ensure that the borrower will carry on with the operation of its business during the loan life in the same terms which were presented to the lender when the loan was extended. This covenant should solve the asset substitution source of conflict mentioned previously [98]

[95] *The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions*, *supra* 68, p. 158.
[96] Krass Monroe, *supra* note 68, p. 25.
[97] Krass Monroe, *supra* note 68, p. 23.
[98] *See* p. 13 above.

through this requirement that the business line which he examined while extending his loan, would be preserved.

> "Borrower shall continue, and shall cause each subsidiary to continue, to own its properties and conduct its business in the same manner as the same are owned and conducted as of the date of this Agreement." [99]

Delivery of Proof of Covenants Compliance and *Notification about Agreed Events.* The covenant frequency of former is 89% and latter is 25%. This type is related to above mentioned information covenants and it shifts the burden of monitoring from the lender to borrower or its management respectively. As the LMA guide comments, it is delivered on regular basis together with the financial documents and it has a standard form.[100] The notice delivery covenant usually requires to promptly delivering notice by the borrower if certain events such as violation of the covenant, material adverse change or any other event occurs.

> "Within thirty (30) days after the end of each fiscal year, Borrower shall provide to Lender a Certificate of Borrower in the form attached hereto ... signed by the Chief Financial Officer of the Borrower;" certificate includes statement that the covenants have been not breached or special procedure is stipulated if the covenant is violated;
>
> "Borrower shall promptly notify Lender of any of the following, but in no event later than three (3) business days after any Responsible Officer of Borrower obtains actual knowledge thereof: [Event of Default], [breach under, any contractual obligation], [any dispute, litigation exceeding certain limit], [any material adverse change in the assets, liabilities and net worth], [any material labor controversy]." [101]

Payment of Taxes and Performance of Obligations- The covenants frequency is 82 %. The function of this covenant is to protect lender from the claims of other creditors and as such deal with the claim dilution. In the event of default with performance of obligations under other contracts or statutory duties, other creditors or state may bring their claims, or even start with a foreclosure of the borrower's assets which may cause difficulties to the

[99] *Id.*, p. 24.
[100] *The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions, supra* note 68, p. 113.
[101] Krass Monroe, P.A, *supra* note 68, p. 27.

borrower's business. This is even more problematic, if the lender is unsecured and especially in relation to taxes since the unpaid taxes or other statutory payments may have a senior position in case of bankruptcy in certain jurisdictions. Other reason is that the violation of these obligations may result in fine payments and other sanctions and consequently negatively decrease the value of the borrower's firm.

> "Borrower shall pay and discharge as the same shall become due and payable (a) all taxes, assessments and governmental charges of any kind payable by it, except that is shall contest in good faith and by appropriate proceedings providing such reserves as are required by generally accepted accounting principles, and (b) all lawful claims which, if unpaid, would by law become a lien upon any of the Borrower's assets." and "Borrower shall conduct its business in compliance with all applicable federal, state and local laws, rules, regulations, ordinances and orders, whether judicial or administrative, and whether arising under common law, statute or otherwise." [102]

Maintain properties - The covenant frequency is 82%. As already discussed, this covenant type has dual function. Firstly, it should ensure that the borrower's business has all required assets which he needs in sound state, so he might generate sufficient profits necessary for loan repayment. Secondly, it should ensure that in case of default with repayment, the value of borrower's assets will be sufficient to satisfy lender in foreclosure.

> "Borrower shall maintain keep, and preserve, and cause each of its subsidiaries to maintain, keep and preserve, all of its properties, tangible and intangible, real and personal, necessary or useful for the conduct of its business in good and working order and condition, ordinary wear and tear excepted." [103]

2.2.2 Negative Covenants

As discussed above, the negative covenants are promises not to perform certain acts.

Negative Pledge Clause – Paglia in his study mentions the frequency of this covenant only in 18% (but with respect to restriction of borrower's liens the covenant's frequency is

[102] *Id.*, p. 22,23.
[103] *Id.*, p. 23,24.

55%) but other authors such as Wood[104] state that this covenant is one of the most important covenants in an unsecured loan agreements. The function of this covenant is to ensure that the lender may satisfy from the assets of the borrower without limitations. If the lender is unsecured (*i.e.* he does not have any kind of security in the borrower's assets) and the borrower will create security interest, such as lien, over his assets for the benefit of another creditor, the lender's position is seriously threatened because his claim would be subordinated to the claim of such third creditor in case of bankruptcy and subsequently there will be only limited assets from which he may be satisfied. As Wood points out[105], even if the lender is secured and has first ranking security interest, the secondary security interest may cause problems, since the junior creditor may start with its enforcement in inopportune time and additionally, if a lender wishes to lend new loan to borrower after the secondary security interest was granted and secure it with existing security, the junior creditor may veto this.[106]

> "The borrower will not (and will procure that none of its subsidiaries will) create or permit to exist any security interest on any of its assets." [107] Wood points out that the actual wording of this covenant must describe all forms of security interest, but on the other hand it should exclude certain transactions (such as liens with a lender's consent, liens which are created by operational of law).
>
> The LMA guide recommends to include also a quasi-security such as "sale and repurchase or leaseback, debt factoring on recourse terms, and set-off arrangements, including intra-group netting and set-off of bank accounts ... [ples][t]here is a final category catching any other "preferential" arrangement that has a similar effect." [108]
>
> "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower will not, without the prior written consent of Lender, create, incur, or suffer to exist, any mortgage, deed of trust, pledge, lien, security interest, hypothecation or other charge or

[104] Philip Wood, *supra* note 72, 8-08.
[105] Philip Wood, *Id.* note 72, 8-19.
[106] *See also* Bjerre, Carl S., *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection* 84 Cornell L. Rev., (Jan, 1999). Available at SSRN: http://ssrn.com/abstract=167788; and for more details on negative pledge in developing countries, Bradfiel & Jacklin. *The problems Posed by Negative Pledge Covenants in International Loan Agreements* 23 Columbmia J. Trans. L. (1984), p. 131. Available at http://nationalaglawcenter.org/assets/bibarticles/bradfieldjacklin_posed.pdf.
[107] Philip Wood, *supra* note 72, 8-08.
[108] The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions, supra note 66, p. 147.

> encumbrances of any nature, upon or with respect to any of Borrower's properties, now owned or in the future acquired." [109]

Additional Indebtness - The covenants frequency is with respect to restrictions of new loans only in ordinary course of business 34%, with respect to restriction of leases, guarantees and sale-leasebacks[110] 34%, 25% and 30% respectively. Various financial covenants are also used but they will be evaluated later. The function of this covenant is to prevent the claim dilution of the lender by creation of more debts. In addition, even if the borrower has sufficient assets to cover all claims, the high indebtness may cause problems with cash-flow. However, as the Model Covenants Provisions comments, such restrictions should not apply in case the borrower (or issuer in this regard) "has the demonstrated capacity (usually tested based upon a comparison of cash flow to interest expense) to service all its debt including the proposed new debt."[111]

> "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not create or suffer to exist any Indebtedness other than the Note and Indebtedness secured by Permitted Liens;" [the definition of "Debt" and "Indebtness" follows] (i) indebtedness for borrowed monies or for the deferred purchase price of property or services, (ii) obligations as a lessee under leases that have been or should be recorded as capital leases, (iii) obligations under direct or indirect guaranties in respect of any obligations (contingent or otherwise) to purchase or otherwise acquire, or otherwise to assure a creditor against loss in respect of, indebtedness or obligations of others of the kinds…" [112]

Restrictions of pay-outs - The covenant frequency of dividend restrictions is 47% and additional 25% has other payment restrictions. Restriction of stock repurchases and stock redemptions have together only 22%. As was already discussed in the section 1.3, the function of these restrictions is determined by the fact that if the asset's value is paid back to

[109] Krass Monroe, P.A, *supra* note 68, p. 30.

[110] "A sale leaseback transaction, where the Company sells an asset and immediately leases it back, is economically very similar to a secured financing, since the Company will receive sale proceeds (similar to loan proceeds) and will make rental payments over the life of the lease (similar to loan repayments)." Model Covenants Provisions, *supra* 17, 4.10.

[111] Model Covenants Provisions, *supra* note 17, 4.10. Similarly, the LMA guide also acknowledge this and it enumerate the typical list of permitted transactions. The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions, *supra* note 66.

[112] Krass Monroe, P.A, *supra* note 68, p. 30.

the stockholders through dividends or through other similar means, no available assets are available for satisfaction of lender's claims. However, as the LMA guide comments in specified situations, especially when no event of default occurs, lenders to the limited extend allow some pay-outs (known as "permitted distributions"). The same effect may also have the restrictions on salary and bonuses of management[113], however according to Paglia's study percentage of such covenants is below 5%.

> "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not purchase or redeem any of its equity interests, declare or pay any distributions thereon, make any cash or property distributions to equity holders, or set aside any such funds for such purpose." … "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not purchase or redeem any of its equity interests, declare or pay any distributions thereon, make any cash or property distributions to equity holders, or set aside any such funds for such purpose; provided, however, that in the absence of an Event of Default…[other restrictions follow]." [114]

Restriction on control, ownership and sales of substantially all assets - The covenants frequency with respect to restrictions of change in ownership or takeover is 46%, restrictions of mergers or consolidations is 78%, and restrictions of asset transfers is 22%. The function of this covenant is to assure "the lender the composition and business of the borrower remains the same over the life of the loan." [115] It preserves the *status quo* of corporate structure, business operations and assets as of the time of loan extension. However, as Model Covenant's Provisions stipulate in certain situations, the exemption may be granted provided that "there be no decrease in consolidated net worth as a result of the transaction" and "the successor or survivor in any major transaction involving the Company including the transferee of substantially all the assets of the Company, assumes ... [the obligations with respect of the loan (or securities in this case)]."[116]

[113] *Id.*, p. 33.
[114] *Id.*, p. 31.
[115] *Id.*, p. 32.
[116] Model Covenants Provisions, *supra* note 17, 4.13.

> "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not wind up, liquidate or dissolve itself, reorganize, merge or consolidate with or into, or convey, sell, assign, transfer, lease or otherwise dispose of, (whether in a single transaction or series of transactions), all or substantially all of its assets (whether now owed or in the future acquired) to any other Person, or acquire all or substantially all of the assets or business of any Person." [117]

Transactions with Affiliates and Subsidiaries - The covenants frequency is 66%. The function of this covenant is maintenance of the assets value. In case of affiliated transactions, there is a risk that such transaction would not be based on the market conditions and therefore the assets can get out from the company without adequate consideration and again there will not be enough money to satisfy the lender. As LMA guide comments such transactions may be allowed, provided that they are carried out "on arms' length basis and for full market value."[118]

> "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not engage in any transaction (including, without limitation, loans or financial accommodations of any kind) with any Affiliate, provided, that such transactions are permitted if they are on terms no less favorable to the Borrower than would be obtainable in an arm's-length transaction with a person not an Affiliate." [119]

Restrictions on investments - The covenant frequency is with respect to restrictions on capital expenditures 49% and restriction on acquisitions is 29%. The function of this covenant is to maintain the assets value. If the borrower's risky investment financed from his assets fails, the lender will not have assets available for his satisfaction.

> "For so long as the Note shall remain unpaid or any Obligations shall be outstanding, Borrower shall not make any loan or advance to any Person, or purchase or otherwise acquire the capital stock, assets, or obligations of, or any interest in, any other Person other than readily marketable direct obligations of the United States of America and deposits in commercial banks of recognized good standing in the United States of America." [120]

[117] Krass Monroe, P.A, *supra* note 68, p. 32
[118] The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions, *supra* note 66, p. 152.
[119] Krass Monroe, P.A, *supra* note 68, p. 34.
[120] *Id.*, p. 34.

Limitation on sales of assets - The covenants frequency with respect to sale of assets in ordinary course of business is 34% and other restrictions on asset transfers is 22%. The Model Provisions Covenants claims that although this restrictions usually "require[s] sales of assets to be made at fair market value" and "that a large percentage of the consideration be received in cash", the main purpose is to specify how "the proceeds are to be used;" and the rule is that "the Company [borrower] should not sell revenue-producing assets unless the proceeds are either reinvested in revenue-producing assets" or "used to repay debt ... and "long-term assets should not be sold to effectively provide working capital." [121]

> "The Company shall not …, directly or indirectly, consummate any Asset Disposition unless (1) the Company or such Restricted Subsidiary receives consideration at the time of such Asset Disposition at least equal to the fair market value (including as to the value of all non-cash consideration), as determined in good faith by the Board, of the shares and assets subject to such Asset Disposition; (2) at least 80% of the consideration thereof received by the Company or such Restricted Subsidiary is in the form of cash or cash equivalents." … (3) an amount equal to 100% of the Net Available Cash from such Asset Disposition is applied by the Company…"[122] the rule on how the proceeds should be used follows.

2.2.3 Financial Covenants

The financial covenants are in their substance also negative covenants, since they also represent promises of borrower not to breach certain rules. The difference is that in contrast to negative covenants which borrower can directly influence (e.g. he will not pledge his assets, or he will not sell his assets), the financial covenants typically do not directly depend on borrower's actions and are rather due to matters beyond its "control, such as the state of the industry, market trends, etc., and fail to comply with the financial covenants."[123] As Paglia points out "[f]inancial covenants are requirements or restrictions related to specific balance sheet, income statement, or cash flow items; [t]his type of covenant is objective in

[121] Model Covenants Provisions, *supra* note 17, 4.06.
[122] *Id.*, p. 4.06.
[123] Krass Monroe, P.A, *supra* note 68, p. 35.

nature and is measurable and verifiable."[124] Through these mathematical numbers the lender may control the operation of borrower's business and ensure that it is at least on the same level as it was when the loan was negotiated. Additionally as Bratton comments together with early warn covenants, they may warn the lender that the borrower's business is in trouble in case the relevant financial coefficient drops below agreed limit and it enables to proceed accordingly even if all other covenants are complied with.[125]

- *Liquidity Financial Covenants* – They require holding minimum level of assets which are easily convertible into cash without substantially decreasing value of such assets. The function of this covenant is to ensure the "company's ability to pay back its short-term liabilities (debt and payables) with its short-term assets (cash, inventory, receivables),"[126] or in other words to ensure the level of resources available to borrower to operate his business when needed. Only firm with duly operating business can fulfill claims of a lender and other creditors. The covenant frequency is 17%. The most typical liquidity financial covenants are *minimum working capital* and *current ratio*. The former requires a minimum working capital available for borrower. Working capital is calculated as the excess of a borrower's current assets over current liabilities where (i) *current assets* typically refers to assets that are readily convertible into cash (usually within one year), such as cash, accounts receivable, inventories and prepaid expenses and (ii) *current liabilities* generally refers to obligations that must be satisfied within one year.[127]

> The wording of minimum working capital covenant usually includes that the excess of current assets over current liabilities exceed certain dollar value or percentage from another changeable value.[128]

[124] John Paglia, *supra* note 19, p. 109.
[125] William Bratton, *supra* note 74.
[126] Investopedia, online dictionary. Available at. http://www.investopedia.com/terms/c/currentratio.asp#ixzz1qGA7zY2K.
[127] Which entries from balance sheet should be subject to current assets or current liabilities differe. This example is provided from the work by law firm Krass Monroe, P.A. *Loan Documentation: An Introduction for Small Businesses*. *supra* note 68, p. 36.
[128] *Cf.* Peter Nevitt & Frank Fabozzi, Project Financing, (7th ed. 2000), p. 116.

The current ratio is calculated as the ratio of current assets to current liabilities. Since the value of this covenant is only proportion of two variables, in contrast to minimum working capital, which is usually absolute number may better, this current ratio covenant may better reflect the growth of the borrower. If certain inventories and receivables are excluded due to their limited availability to be converted into cash in their liquidation without depreciating their value, this covenant is called a quick ratio.

> "Borrower shall maintain a ratio of current assets to current liabilities of not less than 1.5 to 1."[129]

- *Equity Financial Covenants* – These covenants require minimum level of equity for borrowers. The covenants frequency is 58%. The most typical covenant is a *net worth covenant*. The function of this covenant is to preserve the value of the firm available to the lender for his satisfaction through requirement of minimum value that must a firm has after all its liabilities are satisfied. It is calculated as a difference between all of borrower's assets minus all of borrower's liabilities. The issue for drafting of this covenant is which entries should be covered in calculation of the assets and which in calculation of the liabilities[130]. If this answer is clear the actual wording is not problematic.

> "Borrower shall maintain at each fiscal year end a tangible net worth of not less than [specific dollar amount to be inserted taking into account circumstances of a particular case]." [131]

- *Debt and Leverage Financial Covenants* – These covenants again limit the debt value through maximum ratio of debt to equity or to cash flow. The most typical covenant in this group is *debt to equity ratio* (sometimes called *leverage ratio*) with frequency of 46%. This covenant is a ratio between amount of borrower's debt in relation to the amount of his equity, or in other words if the ratio is 2:1, it means that on one dollar invested by the borrower, there are two dollars of debt. The intention of the borrower is generally to have high ratio, since for him it means that he has higher amount available (*e.g.* one dollar own and three dollars

[129] Krass Monroe, P.A. *Loan Documentation: An Introduction for Small Businesses*. *supra* note 68, p. 41.
[130] If the assets which have low value or are difficult to convert into cash are excluded, we speak about tangible net worth.
[131] *Id.*, p. 37.

borrowed, altogether 4 dollars) for his profit generating investment than he would have if the ratio is low (*e.g.* one dollar own and two dollars borrowed, altogether only 3 dollars), so he can used borrowed money for investment and save his own money for other investments. On the other hand, lender's incentive is to have sufficient amount of the borrower's equity to cover his claims.

> "Borrower shall maintain a ratio of total liabilities to tangible net worth of not greater than 3 to 1 and a ratio of consolidated total liabilities to consolidated tangible net worth of not greater than 4 to 1."[132]

- *Coverage and cash flow covenants* – This covenant ensures debt repayment through the requirement of some amount of cash flow or a certain level of cash flow in relation to payment of debt. The most typical is *debt service coverage ratio* with frequency of 44%. According to investor's guide, in this covenant debt service (*i.e.* cash necessary to pay principal together with interest in given time period) is compared with the amount of cash flow available in such time period[133], or in other words a DSCR of 1.3:1 means, that for every one dollar of debt service in given period, the company must have 1.3 dollar of cash available in such period to cover it. Lenders obviously prefer that this ratio is higher, so they will have a cushion for unforeseeable events. Borrowers prefer it lower, since it means not used cash which they may invest otherwise.

> "For each fiscal year beginning with the fiscal year ending on December 31, ... , DSCR for Borrower shall not be less than 1.1:1." [134]

Other typical covenant in this group with its frequency of 31% is *fixed charge coverage ratio*. It aims on the borrower's ability to pay fixed charges (*i.e.* fixed financing expenses such as loan payments, rent). Similar covenant is *debt to EBITDA ratio*. The function is to warn lender about insufficient cash available for repayment of the debt or is

[132] *Id.*, p. 39.
[133] Investopedia, online dictionary. Available at. http://www.investopedia.com/terms/d/dscr.asp#axzz1qR9BWahy.
[134] *Id.*, p. 40.

used in relation with other clauses in order to determine the borrower's ability to accept additional debt. "This ratio gives the investor the approximate amount of time that would be needed to pay off all debt, ignoring the factors of interest, taxes, depreciation and amortization."[135] It is calculated as a ratio of the borrower's debt to his cash flow calculated as EBITDA – earnings before interest taxes, depreciation and amortization.

- *Investment Covenants* – The function of this covenant is to deal with asset substitution discussed in section 1.3 and it limits the ability of the borrower to invest in other project through purchasing capital assets (i.e. assets to be used in longer time period), because such assets are difficult to liquidate without causing material adverse effect to the borrower's business.[136] The covenants frequency of maximum capital expenditures is 26%.

> "Borrower shall not make any expenditures for fixed or capital assets if, after giving effect thereto, the aggregate of all such expenditures made by the Borrower would exceed 2% of net profit during any fiscal year of the Borrower." [137]

One of the conclusions from the above analysis of financial covenants is that it is obvious that the financial covenants need to be drafted with respect to each borrower specifically, since they can be only effective if the circumstances and parties incentives of the particular case are taken into account.

To sum up above, the full set of covenants (affirmative, negative and financial covenants) as developed under common law represent system of various groups of covenants. A particular loan agreement may not necessarily include all of them, however the statistics say that most of the agreements include at least some of them. The drafters of the agreements usually use the standardized wordings provided that a particular covenant enables it. The above summary on the covenants was necessary to have a sample of covenant which have

[135] Investopedia, online dictionary. Available at: http://www.investopedia.com/terms/d/debt_edbitda.asp#ixzz1qR9L79ti
[136] *Cf* "Capital assets generally cannot be disposed of (sold) by a borrower absent liquidation of the business. Consequently, capital assets are not assets the borrower can use to pay down the loan." *Id.*, p. 38.
[137] *Id.*, p. 38.

been developed in common law and in next chapter, I will evaluate the practice in Slovakia and I will answer the question whether covenants are used in this jurisdiction and if, which of them are used and which are typically drafted in standardized language.

CHAPTER 3. - PRACTICE IN SLOVAKIA

In this chapter I will focus on the banking practice in loan extending by the biggest Slovak banks. First section deals with covenants which may be founded in general terms and conditions. These are general rules binding to the parties of a particular loan agreement by the means of reference, since it is a general practice in this sector that substantial part of rights and obligations are not included directly in the loan agreement but they are included in another document on which parties refer. In the loan agreement parties just agree that such document will be considered as a part of their agreement and conditions included therein would be obligatory for them. Since many loan agreements refer on the same general terms and conditions, these terms and conditions must be drafted in general and standardized language. Bearing in mind that the covenants usually have standardized form, the general terms and conditions seem to be therefore the best place where covenants might be found. This presumption should be confirmed below. I will evaluate which covenants as described in the previous chapters are included therein and what is their usual wording.

Second subsection deals with two concrete loan agreements and covenants included therein. In this part I will answer the question, whether, except of covenants in the general terms and conditions, there are also covenants founded in the loan agreement itself and if which type of covenants are reserved for this place.

3.1 Covenants in general terms and conditions

In my sample I analyse the general terms and conditions of five different banks (hereinafter only as the GTC or GTCs).[138] These GTCs are used with respect to loans which are usually secured by security and which are extended to small and medium entrepreneurs.

[138] The GTC of a bank from Erste group (the "GTCA"). Available at: http://www.slsp.sk/downloads/op_uvery_sme_vns.pdf; (ii) the GTC of a bank from the RZB group (the "GTCB"). Available at: http://www.tatrabanka.sk/cms/att/1431043/VUP_SJ_2008.pdf; (iii) the GTC of a bank belonging to OTP group (the "GTCC"). Available at.: http://static.otpbank.sk/st/s.ashx?i=582 (the); (iv) the GTC of a bank from the KBC BANK group (the "GTCD"). Available at: http://www.csob.sk/Files/Obchodne_podmienky/OP_Uvery_15122011.pdf; and (v) the GTC of a bank belonging to UniCredit Group (the "GTCE"). Available at: http://www.unicreditbank.sk/att/101426/OP_uvery-pre-podnikatelov.pdf.

In all of these GTCs, there was a relevant section which included covenants as were described above. The analysis showed that following covenants were present in the GTCs.

Reporting, Disclosure or Information covenants – In all of the GTCs at least one form of this covenant existed. The most typical is the covenant which obliges the borrower to furnish lender with agreed scope of information.[139] Typically their required following information to be furnished on regular basis: (i) extract from the commercial register (also upon any change thereof), (ii) extract from the registrar of security interest, (iii) tax returns, (iii) auditor reports, (iv) financial statements (even consolidated if applicable); also following information were required in some GTCs (v) all reports and documents which are mandatory to be provided to the stockholders, (vi) relevant business licenses.

Three GTCs included covenant to duly keep books and in accordance with Slovak accounting standards (the US GAAP, IFRS and IAS standards were in also available some GTCs).[140] Three GTSs also included the covenant enabling the lender to inspect the promises of the borrower and his books.[141] Only one GTC included compliance certificate covenant and it is notable that such certificate was mandatory to issue on regular basis only with respect to fulfillment of financial covenants and with respect to other covenants only upon a request of the bank.[142] Only one GTC missed the covenant to notify about various events in agreed scope.[143] This scope was broadly drafted and it mainly included events such as material adverse change, event of default with loan agreement, change in representation and warranties, new pending litigation, filing of the bankruptcy petition etc.

[139] *See* Article 7.4l-p of GTCA; *supra* 138, Article 8.2 of GTCB, *supra* 138; Article VII 2,3 of GTCC, *supra* 138; Article 15 f of GTCD, *supra* 138; and Article 8.2 of GTCE, *supra* 138.
[140] *See* Article 7.4m of GTCA; *supra* 138; Article 8.1b of GTCB, *supra* 138; and 8.1.2 of GTCE, *supra* 138.
[141] *See* Article 16. of GTCA, *supra* 138; Article 15g. of GTCD, *supra* 138; and 8.2.12. of GTCE, *supra* 138.
[142] *See* Article 7.4t, z of GTCA, *supra* 138.
[143] *See* Article 7.4a-f, i of GTCA, *supra* 138; Article 8.1h,i of GTCB, *supra* 138; Article 15j of GTCD, *supra* 138; and Article 8.2.4-11 of GTCE, *supra* 138.

Insurance – All GTCs included insurance covenant (one only however if the loan agreement so requires).[144] This is similar state than in US where the percentage of frequency was also 91%, because typically the risk of unforceeable events is to be covered in both jurisdictions through insurance. As recommended above, the covenants specified that the insurance should be made only with respectful insurance companies (or companies acceptable for the lender) and in the extent usual for similar businesses in Slovakia. The scope should cover insurance of assets against common risk and in some GTCs also it should cover damages caused by the borrower to third parties. Usual stipulation is that the lender would be an insuree (i.e. person who directly benefit from the insurance). The payment of the insurance fee is mandatory to be evidenced in most of the GTCs.

Maintenance of Corporate Existence – in none of the GTCs such covenant existed. However, similar effect had the representation and warranties (hereinafter R&W) which stipulated that the company is duly formed at the time of contracting and the obligation that such R&W would be true also in future. In general GTCs try to achieve the same effect through stipulation that event causing that the borrower's firm is dissolved (such as petition for voluntary or statutory liquidation, petition for bankruptcy or restructuring *etc*.) would be an event of default.

Preservation of Line of Business – This covenant existed in the various forms in three GTCs.[145] Typical was the covenant that the borrower will conduct its business without any material change and will follow the purpose of his business on which the money were provided. Even negative form of this covenant was present, since the borrower covenanted in two GTCs that he will not make any change on his business that would cause material adverse effect on it.

[144] *See* Article 7.4r of GTCA, *supra* 138; Article 11.1 of GTCB, *supra* 138; Article III 5 of GTCC, *supra* 138; Article 15i of GTCD, *supra* 138; and Article 8.1.3 of GTCE, *supra* 138.
[145] *See* Article 7.5i of GTCA, *supra* 138; Article 8.5a of GTCB, *supra* 135; and Article 8.1.5 of GTCE, *supra* 138.

Payment of Taxes and Performance of Obligations - only one GTC included covenant on payment of law required payments (namely taxes, custom duties, fees and other payments required by laws) and the same GTC expressly included also covenant of borrower to perform his obligations from other contracts.[146] In some other GTCs however, a violation of such duties would cause an event of default.

Maintain all licenses – this covenant was not mentioned by Paglia in his work, however in four of five GTCs, the borrower covenanted that he will consecutively bear all licenses, assents and concessions necessary for conducting his business.[147]

Maintain of properties – there were no substantially same covenants as decribed above in this regard. However two GTCs included that the borrower will not make any substantial changes on his properties (one had it as an event of default).[148]

Negative pledge – three GTCs (and one had it as an event of default) included the negative pledge covenant. Exemplary covenant reads as follows "[t]he Borrower shall not establish, and shall not allow that it is established, any security interest, encumbrance, or any other limitation of disposing with his current or future assets in favor of any other third person without prior written consent of the Bank which might be subjected for example by Additional Claim Security for Bank."[149] From this practice it is obvious that the lenders even in secured loans wish to have no additional security interest established over their collateral.

Additional Indebtness – Three GTCs included restrictions on establishment of additional debts.[150] The typical provision which is modified in these covenants restrict acceptance of further loan, or just restriction on additional debt was present. They also restrict other means through which the indebtness of the borrower may arise such as provision of a

[146] *See* Article 8.1c and f of GTCB, *supra* 135.
[147] *See* Article 7.4u of GTCA, *supra* 138; Article 8.1e of GTCB, *supra* 138; Article 15a of GTCD, *supra* 138; and Article 7.1.1 of GTCE, *supra* 138.
[148] *See* Article 7.5b of GTCA, *supra* 138; and Article 8.5a of GTCB, *supra* 138.
[149] *See* Article 7.5 d of GTCA, *supra* 138. *See also* 8.5b 5a of GTCB, *supra* 138; and 8.1.5d of GTCE, *supra* 138.
[150] *See* Article 7.5e of GTCA, *supra* 138. *See also* 8.5c of GTCB, *supra* 138; and 8.1.5g,h of GTCE, *supra* 138.

guarantee, acceptance of debt and accedence to existing contract. It is interesting that in this regard that the borrower, based on this covenant, cannot even voluntary forgive debt which another third party dues him.

*P*ari *passu* covenant which was omitted by Paglia, however identified by other authors also existed in the GTCs.[151] They basically required that the borrower must accommodate that all claims of a lender vis-à-vis him must have at least the same equal position as any other unconditional, unsecured and unsubordinated claims of his other creditors, unless mandatory bankruptcy, liquidation and reorganisation rules require otherwise.[152]

Restrictions of pay-outs – In contrast to US practice the covenants included in the GTCs did not deal with this issue. Only in one GTC, the pay out of dividends without previous consent of the lender would cause an event of default. The answer why this is so may be that such restrictions can be stipulated on the loan agreement itself, since direct general restriction in this regard would be not acceptable for most of the borrowers. On the other hand the dividend restrictions were included in only 47% of the loans in the Paglia's study. Another reason why there are no such restrictions in this regard might be that such issues in Slovakia, as part of European continental system, are more strict regulated by statutory legal acts[153], whereas in US (or at least in majority of the jurisdictions), the approach is different and the creditors need to protect themselves in contracts, in contrast to European continental system, in which laws are adopted for the creditors' protection.

Restriction on control, ownership and sales of all or substantially all assets – The restriction on mergers and consolidations was expressly included in one GTC.[154] This covenant restricted all acts heading to merger, consolidation, split, or change of the legal

[151] *See* Hudson, *supra* 78.
[152] *See* Article 7.4 g of GTCA, *supra* 138; 15d of GTCD, *supra* 138; and 8.1.4 of GTCE, *supra* 138.
[153] The legal regulations in Slovakia on dividends payment policy is influenced by European legislation. *See*, article 15 of Second Council Directive 77/91/EEC *on coordination of safeguards which, for the protection of the interests of members and others*, OJ L 26.
[154] *See* Article 7.5l of GTCA, *supra* 138.

form without prior consent of the lender. Change of ownership covenant only upon prior written consent was also founded in this GTC.[155] In other GTCs the aforementioned constituted an event of default if exercised without prior consent or if exercised without prior notification. Sales of all or substantially all assets[156] covenant was an event of default in two GTCs, unless prior written consent of the lender was granted.

Transactions with Affiliates and Subsidiaries – None of the GTCs dealt with the restrictions of transactions with affiliated or related persons of the borrower. The reason why this is so, might be that the restrictions related with this covenant as were described previously (arm's length principle), are stipulated by statutes in Slovakia. The Slovak Commercial Code requires that if a company makes transaction with any related party exceeding certain amount level, the value of the property in given transaction, must be evaluated by independent appraiser and the appraisal report must be filed with public registrar otherwise such transaction would be ineffective.[157] Therefore the statutory protection in this regard is relatively strong and it is understandable why no covenants were included in this regard.

[155] *See* Article 7.5k of GTCA, *supra* 138

[156] Sales of all or substantially all assets in Slovakia is carried out according to special legal mechanism called "sale of an enterprise" which is defined according to §5 of Slovak Commercial Code as "[enterprise is] whole of tangible, intangible and personnel assets, which are used in business" and as such they represent all assets of the company. The consequence is that a seller of the enterprise *ex offo* guarantees the debts which were related with that enterprise. Even, if the parties would like to cover such transaction in different contract, the court practise is to lift this "cover" and it would apply substance over form rule and the court would apply the mechanism of sale of an enterprise. *See* Matus Valkucak, *Contract on sale of enterprise (Zmluva o predaji podniku)*, (2010), p. 29,30.. Available at: https://stella.uniba.sk/zkp-storage/ddp/dostupne/PA/2010/2010-PA-dgdRCo/2010-PA-dgdRCo.pdf.

[157] *Cf.* "If a company acquires property under an agreement entered into with their founder, member or shareholder against consideration equal to not less than 10% of the re gistered capital, the value of the property must be determined by an official appraiser. Such an agreement shall not be effective prior to its filing into the Collection of Deeds together with the appraisal ... [t]he provisions ... above shall apply, mutatis mutandis, also to agreements, which are entered into between the company and parties, which are regarded as close parties of founders, members or shareholders thereof, or which have control or are controlled by the founders, members or shareholders, always provided that the company acquires property against a consideration of not less than 10% of their registered capital." §59a of Slovak Commercial Code. This provision stems from the Second Council Directive, *see* Article 11 of Second Council Directive 77/91/EEC *on coordination of safeguards which, for the protection of the interests of members and others*, OJ L 26.

Restrictions on investments - Two GTCs included restrictions on accepting or extending any additional loan and restriction of acquisition of control through ownership of more than 5% of shares in another companies without prior consent of the lender. [158]

Limitation on sales of assets – Two GTCs included covenant according to which a borrower cannot execute any material changes on his assets by selling, donating, granting as a security, or renting them, and one of them restricted also sale of assets exceeding certain threshold.[159] No other restrictions could be founded. The reason for this may be that these GTCs are assign for loan agreements which are secured by another security interest. Lenders typically require that all assets of a borrower (such as real estate, tangible assets, intangible assets, account receivables and future assets) are used as collateral. Once perfected (typically after registration with the relevant registrars) the lender is protected against third parties since in case of sale of a particular asset, the right of the lender in such assets persist. The covenants on limitation on selling of the assets in this regard would not grant much additional benefit to this secured loan. The contractual limitation on selling an asset would not prevent hiding this asset if borrower so decides (other covenants such as previously mentioned right to inspect however may be helpful). On the other hand many covenants in the GTCs dealt with the preservation of the value of collateral. In case of depreciation of the collateral's value, the borrower according to three GTCs must provide additional security, so that the position of the lender would be the same as there had been no such depreciation.[160]

Financial covenants – No GTCs included any particular financial covenant. However three of them referred to the concrete loan agreements and they included a general covenant that the borrower must comply with any financial covenant which might be concluded in the

[158] *See* Article 7.5e, j of GTCA, *supra* 138; and Article 8.5a of GTCB, *supra* 138.

[159] *See* Article 7.5b,c j of GTCA, *supra* 138; and Article 8.1.5h of GTCE, *supra* 138; *see also* "borrower will not sell or otherwise dispose its long term assets, nor assets which represent a Collateral, including contributing it in another business entity as contribution in kind, not if such assets would be leased-back, or otherwise granted to use by borrower." 8.1.5c of GTCE, *supra* 135.

[160] *See* Article 7.4w of GTCA, *supra* 138; Article 11.4 of GTCB, *supra* 138; Article 14 of GTCC, *supra* 138.

concrete loan agreements.[161] In addition, they prescribed how certain values should be calculated in the financial covenants' formulas. Therefore, these GTCs provide a presumption that financial covenants exist in Slovak practise, however only in concrete loan agreements.

In the table below I compared existence of covenant under each given GTC with a percentage of frequency of covenants in US according to Paglia's study.

Covenant[162]	**GTCA**	**GTCB**	**GTCC**	**GTCD**	**GTCE**	**US %**
A. Operating Activity Covenants						
Preserve existence	*EoD*	*EoD*	*EoD*	*EoD*	*EoD*	*86*
Carry out business without material change	✓	✓			✓	-
Pay taxes/perform obligations	*/EoD*	✓		*EoD*	*EoD/*✓	*82*
Restrict use of proceeds						*48*
Comply with laws and regulations	*EoD*			✓	✓	-
Maintain all licenses	✓	✓		✓	✓	-
Restrict transactions with subs & affiliates						*66*
Will not favor other creditors					✓	-
Follow purpose of business	✓				✓	-
B. Investment Expenditure Covenants						
Restrict CAPEX	✓			*EoD*		*49*
Restrict acquisitions	✓					*29*
Limited to cash and equiv.						*47*
Max. employee loans						*49*
Restrict on investment in subsidiary						*27*
C. Asset Sale Covenants						
Restrict asset transfers	✓				✓	*22*
Asset sales in ordinary course of business						*39*
Asset sales basket provided						*43*
D. Cash Payout Covenants						

[161] *See* Article 7.4t of GTCA, *supra* 138; Article 9.1 of GTCB, *supra* 138; Article 14d of GTCE, *supra* 138

[162] *EoD* - means that the entry exists in the GTC as an event of default. .
i - means that the entry exists in the GTC as an obligation to inform.

Dividend restrictions				*EoD*		*47*
Other restricted payments						*25*
Stock repurchases/ redemption stock						*22*
E. Financing Covenants						
New debt in ordinary course of business only						*33*
Restrict of additional debt	✓				✓	
Restrict loans to subsidiaries						*37*
Restrict guarantees	✓					*25*
Restrict leases						*34*
Restrict sale-leasebacks					✓	*30*
F. Reporting and Disclosure Covenants						
Furnish financials	✓	✓	✓	✓	✓	*95*
Proof of covenant compliance	✓					*89*
Keep proper records	✓	✓			✓	*72*
Inspection of books/property	✓			✓	✓	*75*
MAC/notification of litigation/ default	✓	✓		✓	✓	*25*
Accounting method or fiscal year	✓					*31*
G. Preservation of Collateral /Sr. Covenants						
Negative pledge	✓	✓		*EoD*	✓	*18*
Maintain value of collateral	✓	*EoD*	✓	*EoD*		*15*
Maintain security agreement	✓					*11*
Restriction on guaranteeing debt	✓	*x*			✓	*6*
Pari passu	✓			✓	✓	-
Maintain properties	✓	✓		*EoD*		*82*
Purchase insurance	✓	✓	✓	✓	✓	*91*
H. Mgmt., Control & Ownership Covenants						
Restrict change in management or board	*i*	*EoD*				*4*
Restrict change in ownership/takeover	✓	*EoD*	✓	✓		*46*
Restrict mergers or consolidations	✓	*EoD*	✓	✓	*EoD*	*78*

3.1.1 Practice in loan agreements

In this section, I examine two loan agreements randomly chosen from the publicly available source,[163] in order to consider whether any specific changes in covenants in particular loan agreements exist and whether there are any additional covenants included.

Firstly, I will focus on the covenants in the previous section. All covenants from the general terms and conditions were applicable also in the examined loan agreements by the means of reference on a general terms and conditions. As such they include: covenant (i) covenant to duly keep books, (iii) to duly pay taxes, custom duties, fees and other statutory payments, (iv) to maintain all necessary licences, (v) to comply with other obligations under contracts with the lender and third parties, (vi) to notify material adverse change, events of default and other agreed events, (vii) to furnish financial documents, (viii) not to carry out any material changes on its assets, (ix) negative pledge, (x) not to use alternative sources of finance (such as factoring), (xi) pari passu, (xii) on insurance.

In addition the agreements include also following covenants: (i) restriction of additional indebtness - particularly, the borrower covenanted "not to enter into another loan or other agreement, or one-side declaration, based on which he would be obliged pay back any monetary funds;"[164] (ii) notification of change in ownership structure with specific set thresholds, (iii) debt to equity ratio – that the ratio of equity/debt must be 60% at maximum, (iv) coverage ratio - it was agreed that ratio of EBIT/debt service must be at least 2.0 (in first agreement) resp. 2.5 (in second agreement), (v) current ratio - it was agreed that ratio of current assets/current liabilities must be 2.00, or 2.5 at maximum.[165]

[163] In Slovakia state and other public authorities have a duty to publish agreements to which they are a party and which exceed certain value threshold. First is the agreement with company in which a municipal is major stockholder (First Agreement). Available at: http://www.southerm.sk/dokumenty/document2011-03-17-100639.pdf; and second agreement is with a state undertaking. Available at: http://www.crz.gov.sk/index.php?ID=269061&l=sk. The only criterion was that such agreements must refer to general terms and conditions examined in previous section (all referred to GTCB).

[164] Second agreement, *supra* 163, p. 3.

[165] In all three previous financial covenants the standardized statutory entries should be used in this calculation.

The above analysis of general terms and conditions of Slovak banks showed that the covenants are used in the practice in Slovakia. The most typical covenants which existed according to Paglia's study in more than 85% of his loan sample (such as covenant to furnish information, covenant to insure property, covenant to notify about material adverse change, restrictions on additional debt), or covenants which are according to other authors important (such as negative pledge, pari passu), exist also in given general terms and conditions. The covenants, which missed in Slovak practice, usually did not have also high frequency in Paglia's study, or I provided possible explanations for reasons why they missed.

Other conclusion is that covenants are used in standardized form. It should be noted that if a covenant is used in these terms and conditions, then its actual usage in particular loan agreements which refer to such terms and conditions can be counted in hundreds. Although it is possible that in concrete loan agreement, a covenant from the terms and conditions might be modified, but based on my experience, the actual percentage of such changes will not be high because in Slovakia, banks are reluctant to change their fundamental documents and the bargaining position of borrowers is usually low. Typical changes may moderate such covenants or exclude them, but no material alternations in the drafting happen. Both bankers and investors are aware that enforcement and monitoring of covenants would be easier, if covenants are drafted in the standard form.

The examination of the concrete loan agreements confirmed that the covenants included in general terms and conditions were not changed in the given loan agreements. Additionally, it was confirmed that certain covenants which were not included in terms and conditions, could be found in the concrete loan agreements. Such covenants, which are founded only in loan agreements, are financial covenants which require taking into account circumstances of the particular loan.

CONCLUSION

Comparison of the system of business covenants in US with the legal documents used by Slovak banks revealed that in both jurisdictions essentially the same covenants are used. Further, it was confirmed that the covenants are drafted in standardized form and that they do not materially differ between different banks. Thesis also proved that the practice in civil law does not need to create its specific equivalent of concept of covenants, but it satisfied with taking over of this concept as it was developed in US. In both systems stockholders and investors are seeking their own wealth and as such they have different and antagonistic interests. The covenants, through restricting borrowers from doing certain actions or ordering them to act in certain way, limit the sources of the conflicts between stockholders and investors. The borrowers also benefit from them because if their business is restricted in this sense, they can get better financial terms and conditions of their loans.

This work has shown which the most typical covenants are and what each particular covenant is trying to achieve. If a borrower understands this, he may ask his investor to exclude some covenants which are not necessary and are only burdensome for him. Similarly, if a lender knows which the biggest risks in his partner's business are, by understanding the function of each particular covenant, he may focus on limiting these risks by choosing right set of covenants.

This thesis did not explore all types of covenants which might exist in Slovak practice, but it might be an instruction for making a bigger loan agreements sample in which other covenants might be revealed. On the other hand, the thesis analyzed the general terms and a condition of various banks and it is reasonable to conclude that there are hundreds of loan agreements with substantially the same set of covenants.

Taking into account the low amount of bond issues in Slovakia, the thesis' aim was not to focus on practice in this area, but understanding the problem that the lenders and

bondholders face basically the same issues can lead in further research in this area. On the conclusion that the covenants are drafted in standardized language (unless specific covenants such as financial covenants require otherwise), the further legal studies may build on this thesis in evaluating how the covenants are interpreted and enforced by Slovak courts. Even business practitioners may use this thesis in their future studies and find out if the determinants of the actual sets of covenants are the same as they were founded by American business scholars. Thesis revealed many areas for the future researches and it is a benefit for anyone who is interested in knowing what the system of covenants in Slovakia is.

BIBLIOGRAPHY

Books:

1. Alastair Hudson, *The Law of Finance*. Sweet & Maxwell, (1st. ed. 2009);
2. Alfred W.B. Simpson, *A History of the Common Law of Contract*. Oxford: Oxford University Press, (1st ed. 1975);
3. Bill Roark & Ryan Roark, *Concise Encyclopedia of Real Estate Business Term*. Routledge, (1st ed. 2006);
4. Grant Gilmore, *Security Interest in Personal Property*. The Lawbook Exchange, (2nd ed. 1965);
5. Martijin Empel et al., *Financial Services in Europe*. Wolters Kluwert, (1st ed. 2008)
6. Peter Butt, *Land Law.* Thomson Reuters, (2d ed. 1988);
7. Peter Nevitt & Frank Fabozzi, *Project Financing*. Euromoney Books, (7th ed. 2000);
8. Philip Wood, *Law and Practice of International Finance*, Sweet & Maxwell, (3rd ed. 2008);
9. Runge, C. Julia, *Covenants in Kreditverträgen.* Rws Kommunikationsforum, (1st ed. 2010);
10. Stephen Barkoczy, *Australian Tax Casebook. McPhearson's* 145 (10th ed. 2010);
11. Thierhoff M. et al., *Unternehmens-sanierung*. Heidelberg (1st ed. 2012);
12. William W. Bratton, *Corporate Finance*. Foundation Press (5th ed. 2003);

Articles

13. Allen P. K. Keesee, *The Civil Enforcement of Contractual Covenants*, 12 Lawyer of the Americas, (2, 1980);
14. Arthur von Mehren, *Civil Law Analogues to Consideration: An Exercise in Comparative Analysis* 72 Harv. L., (April, 1959);
15. Bjerre, Carl S., *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection* 84 Cornell L. Rev., (Jan, 1999);
16. Bradfiel & Jacklin, *The problems Posed by Negative Pledge Covenants in International Loan Agreements* 23 Columbia J. Trans. L., (1984);
17. Charles S. Zimmerman, *An approach in Writing Loan Agreement Covenants* RMA Journal, (May 2007);
18. Churchill Rodgers, *The Corporate Trust Indenture Project* 20 Bus. Law, (1965);
19. Clifford W.Smith & Jerold B. Warner, *An Analysis of Bond Covenant* 7 J. Finan. Econ., (1979);
20. Daniel R. Fischel, *The Economics of Lender Liability* 99/1 Yale L.J., (Oct., 1989);
21. Peter Demerjian, *Accounting Standards and Debt Covenants: Has the 'Balance Sheet Approach' Led to a Decline in the Use of Balance Sheet Covenants?* 52 J. Acc. E. 52, (2/3, 2011);

22. Eric Mills Holmes, *Stature and Status of a Promise under Seal as a Legal Formality* Willamette L. Rev., (1993);

23. Gregory A. Ferrence, *Keeping the faith* Smart Business Cleveland, (July 2009);

24. Harlan M. Blake, *Employee Agreements not to Compete* 73 Harv. L. Rev., (1960);

25. Harvey J. Goldschmid, *Antitrust Neglected Stepchild: A Proposal for Dealing with Restrictive Covenants* 73 Colum. L. Rev., (1973);

26. James Gordley, *Louisiana and the Common Law* 24 Tul. Eur. & Civ. L.F., (2008);

27. Jasper H. Arnold, *How to Negotiate a Tem Loan* Harvard Bus. Rev., (March 1982);

28. Jensen & Meckling, T*heory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure* 3 J. Fin. Econ., (1976);

29. John K. Paglia & Donald J. Mullineaux, *An Empirical Exploration of Financial Covenants in Large Bank Loans* 1 Banks and Bank Systems, (2, 2006);

30. John Paglia, *An Overview of Covenants Large in Commercial Bank Loans* The RMA Journal (Sept. 2007);

31. Kevin Chen & John Wei, *Creditors' Decisions to Waive Violations of Accounting-Based Debt*, 88 Acc. R., (April, 1993);

32. Luca Enriques, Jonathan Macey, *Creditor versus Capital Formation: the Case against the European Legal Capital Rules* 86 Cornell L. Rev., 1165 (Sept. 2001);

33. Matthew Billett et al., *Growth Opportunities and the Choice of Leverage, Debt Maturity, and Covenants* 62 J. Finance, (April 2007);

34. Mitchel Berlin & Jan Loeys, *Bond Covenants and Delegated Monitoring* 43/2 J. Finance, (June 1988);

35. *Model Negotiated Covenants and Related Definitions*, 61/4 Business Lawyer, (2006);

36. Ron Box, *How to Effectively Negotiaite Loan Covenants* J. Acc., (August 2010);

37. S. Myers, *Determinants of Corporate Borrowing* 5 J. Fin. Econ., (1977);

38. Weiser Jay, *The Real Estate Covenant as Commons: Incomplete Contract Remedies Over Time* 13 S. Cal. Interdisc. L.J., (2003-2004);

39. William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process* 7 Eur. Bus. Org. L. Rev., (2006);

40. Wolfgang Weitnaur, *Covenants und AGB-Kontrolle* 33 ZIP (2005);

Elecronic sources

41. Black's Law Dictionary (9th ed. 2009). Available at Westlaw;

42. Demiroglu Cem & James Christopher, The Information Content of Bank Loan Covenants (March 5, 2010). Available at: http://dx.doi.org/10.2139/ssrn.959393;

43. Gilson, Stuart. & Warner, Jerold. Private versus Public Debt: Evidence from Firms That Replace Bank Loans with Junk Bonds, (1998). Available at: http://ssrn.com/abstract=140093;

44. Hahn, David, The Roles of Acceleration (January, 2010). Available at: http://ssrn.com/abstract=1547702;

45. Investopedia, online dictionary. Available at: http://www.investopedia.com/terms/d/dscr.asp#axzz1qR9BWahy;

46. John Bouvier, A Law Dictionary (6th 1856). Available at: http://www.constitution.org/bouv/bouvier_c.htm;

47. Krass Monroe, P.A., Loan Documentation: An Introduction for Businesses. Available at: http://www.positivelyminnesota.com/Data_Publications/Publications/All_Other_DEED_Publications/Loan_Documentation_-_An_Introduction_for_Small_Businesses.aspx;

48. Loan Marker Association, Financial Covenants Provisions (2006). Available at: http://www.loan-market-assoc.com;

49. Michael Bradley & Michael R. Roberts, The Structure and Pricing of Corporate Debt Covenants, (May, 2004). Available at: http://ssrn.com/abstract=466240;

50. Model Negotiated Covenants and Related Definitions, 61/4 Business Lawyer; (2006), pp. 1439-1539. Available at: http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=23411776&site=eds-live;

51. Patrick Fengler, *Covenants im Firmenkundenkreditgeschäft der Volks- und Raiffeisenbanken – Eignung und empirische Analyse*. Available at: http://www.dhbwvs.de/fileadmin/content/01_UEBER_UNS/04_Studienangebot/02_Fakultaet_Wirtschaft/Bachelor/Banken_und_Bausparkassen/Schriftenreihe-Dateien/06-08-Covenants.pdf;

52. Slaughter and May, The ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers, (February 2010). Available at: http://www.treasurers.org/loandocumentation/investmentgrade;

53. Slaughter and May, The ACT Borrower's Guide to the LMA Facilities Agreement for Leveraged Transactions (Sept. 2008). Available at: http://www.treasurers.org/loandocumentation/leveraged;

54. Business terms and conditions for loans ČSOB (*Úverové obchodné podmienky ČSOB*). Available at: http://www.csob.sk/Files/Obchodne_podmienky/OP_Uvery_15122011.pdf;

55. Business terms and conditions for loans to entrepreneurs (*Obchodné podmienky pre úvery podnikateľom*). Available at: http://www.unicreditbank.sk/att/101426/OP_uvery-pre-podnikatelov.pdf;

56. Business terms and conditions of Slovenká Sporiteľňa, a.s. for loan provisions to small and midscale entrepreneurs (SME), public and non-profit sector (*Obchodné podmienky Slovenskej Sporiteľne, a.s. pre poskytovanie úverov malým a stredným podnikateľom (SME), verejnému a neziskovému sektoru*). Available at: http://www.slsp.sk/downloads/op_uvery_sme_vns.pdf;

57. General terms and conditions for loans (*Všeobecné úverové podmienky*). Available at: http://www.tatrabanka.sk/cms/att/1431043/VUP_SJ_2008.pdf;

58. General terms and conditions for loans, *OTP Banka Slovensko, a.s.* (*Všeobecné úverové podmienky OTP Banka Slovensko, a.s.*). Available at: http://static.otpbank.sk/st/s.ashx?i=582;

59. Loan Agreement between Tatrabanka, a.s. and Southerm, s.r.o. from January 2011. Available at: http://www.southerm.sk/dokumenty/document2011-03-17-100639.pdf;

60. Loan Agreement between Tatrabanka, a.s. and Vojenský opravárenský podnik Trenčín, a. s. from September 2011. Available at: http://www.crz.gov.sk/index.php?ID=269061&l=sk;

(all about links lastly visited on 30 March 2012)

Cases

61. Brightly v. Norton (1862) 122 E.R. 118;

62. Cryne v. Barclays Bank, (1987) B.C.L.C. 548;

63. David securities Pty & Ors v. Commonwealth Bank of Australia, (1992) 175 CLR 353;

64. Sharon Steel v. Chase Manhattan Bank 691 F.2d 1039,1982 U.S. App;

65. Upham v. Smith, 7 Mass. 265, 266 (1811);

Statutory provisions

66. EC Directive 77/91/EEC on coordination of safeguards which, for the protection of the interests of members and others (2012), OJ L 26;

67. EC Regulation 1725/2003 adopting certain international accounting standards, article 65 and article 17 (2012), OJ L 261;

68. Slovak Act. No. 513/1991 Coll. Commercial Code, as amended (2012).