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Covenants in loan agreements—an analysis of practices within the Swedish high-yield bond sector

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Summary

A high-yield bond is a financing option for a non-investment grade corporation, enabling it to raise funds on the capital market. In light of harsher conditions for senior financing, the development of a liquid high-yield market for bonds may prove a necessary way forward to ensure global competitiveness for Swedish small and medium-sized enterprises (“SMEs”) that typically relies heavily on bilateral- and syndicated bank loans.

The reasons behind issuing a bond instead of turning to senior financing alternatives or stock issuances vary, but usually it is a combination of factors concerning price, control and flexibility. As the owner of notes in a bond, *i.e.*, a long-term, tradable debt, you are eligible to annual remuneration: every year until the bond maturity date, you collect interest. Upon the bond’s maturity, you will collect the value of your investment, known as the *principal*. Due to the lack of controlling rights accompanied with holding debt securities such as bonds, compared to owning shares, investors wish to employ a method for mitigating their risks towards the issuer. Predominantly, this need is accommodated through the usage of *covenants*.

Complex covenant packages are often influential in dictating the terms and conditions of the facilities agreements governing bonds. For many investors, which covenants to employ may be hard to determine. This factor, combined with the need to tailor covenant packages to suit each specific loan agreement, has led to contrasting covenant practices within the Swedish high-yield bond sector. This is evidently supported by this study, and is in part believed to be a result of the fact that the standardized loan agreements that have evolved in the Swedish high-yield bond sector have yet to encompass covenants to any extent. Therefore, this study sets out to map the covenant practices on the Swedish market, including how covenants are drafted in each separate case, thus ascertaining their value for the investor. This objective is accomplished by comparing theoretical purposes behind covenants in loan agreements—derivative of doctrine within financial law—with the actual wording of the clauses employed in agreements within the scope of an empirical survey that has been carried out. In this process, some legal pitfalls were identified, possibly leading to diverging results when comparing the purposes behind employing a covenant with the implication in practice.

The main diverging aspects between purpose and practice were found in negative pledge-covenants—due to their apparent lack of effect towards third parties under Swedish law—and within no-disposal clauses’ and no-merger clauses’ function due to the usage of the vague term *material adverse effect* as an outer limit for the covenants’ applicability. Certain issues related to basket sizes and specific carve-outs were also recognized.

For the most part, the majority of covenants investigated did however seem to provide lenders with the level of protection that was pursued. This means that the theory and practice of most covenants corresponded. Hence, it is concluded that the purpose behind covenants as the carrier of effective enforcement rights against the borrower is fulfilled, even though some possible limitations of a few covenant clauses' legal effect were in fact identified. This conclusion was held by adapting a pragmatic and rational view of covenant practices—not neglecting the power that is vested in the noteholders to accelerate premature payment of the notes (should an event of default under the facility agreement occur)—rather than strictly scrutinizing covenants' effects under the law.

Sammanfattning

En högriskobligation, eller företagsobligation med hög risk, är ett sätt för ett litet eller medelstort företag med låg kreditvärdighet att anskaffa pengar på kapitalmarknaden. I takt med att hårdare krav ställs på seniora långivare så växer betydelsen av en välutvecklad marknad för högriskobligationer i Sverige. Detta är nödvändigt för att bibehålla en global konkurrenskraft hos svenska små- och medelstora företag som ofta är starkt beroende av bilaterala- och syndikerade banklån.

Anledningarna till att ett företag väljer att ge ut obligationer i stället för att uppta seniora banklån eller att ge ut aktier varierar, men är vanligtvis beroende av faktorer såsom pris, kontroll och flexibilitet. En obligation är ett långvarigt, omsättningsbart lån. Ägaren av obligationen är berättigad till årlig ersättning i form av ränta som periodvis betalas fram till obligationens förfallodag. På förfallodagen betalas även obligationens principalsumma ut. Eftersom obligationsinnehavaren likt andra kreditgivare saknar det inflytande över bolaget som innehas av aktieägare så måste andra metoder användas för att reglera riskerna förknippade med kreditgivningen. Detta görs primärt genom användandet av covenanter i låneavtalen.

Komplicerade covenantpaket har ofta en stark inverkan på hur obligationernas avtalsvillkor ser ut i sin helhet. För många investerare är frågan vilka covenanter som ska användas svår att avgöra. Denna faktor, i kombination med behovet att kunna skräddarsy vilka covenanter som ska användas till varje specifikt låneavtal, har lett till en kontrasterande användning av covenanter på den svenska marknaden för högriskobligationer. Detta styrks av denna studie, och antas delvis bero på det faktum att det standardavtal som har utvecklats för den svenska högriskobligationsmarknaden inte innefattar covenanter. Det är i bakgrund av detta som denna studie avser att kartlägga hur covenanter används på den svenska marknaden, inbegripande deras ordalydelse i varje enskilt fall. Därigenom finns en förhoppning att kunna utröna det praktiska värdet av dem för obligationsinnehavare. Detta mål uppnås genom att jämföra det teoretiska syftet som finns bakom olika covenanter, enligt relevant doktrin inom finansiell rätt, med covenanters ordalydelse såsom de är utformade i de låneavtal som är del av den empiriska undersökning som uppsatsen bygger på. Denna process ledde till att flera legala fallgropar kunde identifieras, som tänkbart kan leda till skillnader i resultat vid en jämförelse av covenanters bakomliggande syfte och det syfte de får i praktiken.

De primärt åtskiljande faktorerna mellan det bakomliggande syftet och den antagna praktiska implikationen fanns vid användandet av negative pledge-covenanter – på grund av deras till synes avsaknad av effekt gentemot tredjemän i svensk rätt – och i covenanter som avser att begränsa låntagarens förfoganderätt över bolagets egendom, samt i covenanter som avser att begränsa sammanslagning eller uppdelning av det. I det senare

fallet argumenteras det att anledningen till detta är användandet av terminologin *material adverse effect* som en yttre gräns för covenanternas tillämplighet. Vissa möjligt åtskiljande faktorer mellan syfte och praktik identifierades även vid användandet av vissa basketbelopp samt carve-outs.

Sammantaget konkluderas det dock att majoriteten av covenanterna i studien ger investerare det skydd som är avsett. Detta innebär att syftet bakom covenanter korresponderar med den praktiska innebörden de antas få vid sin tillämpning. Således dras slutsatsen att covenanternas roll som ett effektivt påtryckningsmedel gentemot låntagaren uppnås, trots att vissa begränsningar i ett fåtal covenanters legala värde de facto kunde urskiljas. I stället för att strikt analysera varje covenants legala tillämplighet har denna slutsats dragits genom att anta ett pragmatiskt och rationellt synsätt av hur covenanter används – utan att försumma den befogenhet som obligationsinnehavarna besitter när det kommer till att accelerera betalning av obligationerna i förtid för det fall att ett covenantbrott i enlighet med avtalsvillkoren inträffar.

Preface

I would like to thank Mr. Carl Brodén at CorpNordic for his valuable assistance with this paper, as well as Professor Per Samuelsson for his supportive feedback.

Limited segments of the second chapter have been influenced by a previous paper written by me, called *Subordinated debt financing: An analysis of legal implications associated with mezzanine creditors' secondary priority against senior creditors in debtor's insolvency* (Faculty of Law, Lund University, 2012).

Should any reader be interested in taking part of the results and data of the empirical survey, please do not hesitate to contact me.

Stockholm, January 2014.

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Abbreviations

DCM	Debt Capital Market
LTV	Loan To Value
MAC	Material Adverse Change
MAE	Material Adverse Effect
SME	Small- and medium-sized enterprise
SSDA	Swedish Securities Dealers Association

Definitions

Basket	A term for a maximum amount for a specific exception to a covenant restriction in a loan agreement. If a loan agreement limits the borrowers ability to incur additional debt, unless it is below SEK 5 million, then the 5 million is considered a debt-basket.[2]
Carve-out	An exception to a covenant's applicability in a loan agreement. For example, if a covenant limits the borrower from disposing of company assets, a carve-out would permit the latter to sell property at a fair market value, or to sell property that is obsolete.[3]

[2] Compare with Practical Law, Glossary Item (http://us.practicallaw.com/1-382-3264).
[3] Compare with Practical Law, Glossary Item (http://us.practicallaw.com/0-382-3311?q=carve-out).

1 Introduction

1.1 Background

It is unlikely that anyone with insight into the field of Sweden's debt capital market ("DCM") will have missed the past few years' market trend of non-investment grade corporations issuing high-yield bonds. Despite the trend being on an uprising, the market is immensely underdeveloped compared to other countries.[4] The need for improvement is by some claimed to be abundant, not only to ensure that the stream of capital to Swedish corporations is maintained in spite of possible regulatory actions—but also to broaden the scope of financing options for non-investment grade corporations. It is believed that the high-yield bond will play a crucial role in accomplishing these objectives.

One feature in facilitating for an expansion of the market lies in improving methods of ensuring investors that their capital is safeguarded, thereby increasing their incentive to invest. A key aspect in managing this protection is to improve the usage of covenants in bond terms. To date, little interest has been shown in covenants in high-yield bond terms amongst legal scholars. Even so, the concept of covenants is nothing new; it is probable that covenants of some sort have been employed for as long as there has been a DCM. With time, covenant packages designed for certain securities have evolved in light of experiences held by credit providers—resulting in a creation of standards tied to the instrument to which the covenant is connected to. Since the Swedish high-yield bond market is underdeveloped, it is my belief that it would be beneficial to examine covenant terms of bonds on this market, with the overall objective to find out what might be of importance for an investor's purpose to protect her investment. In the process, I hope that some interesting conclusions will be held as regards the legal implication of certain covenants, in the interest of legal practitioners- and scholars alike.

The need for transparency should also be viewed in light of the lack of covenant coverage within the standardized loan agreement template constructed by the Swedish Securities Dealers Association ("SSDA"), which is utilized for senior unsecured-/senior secured-/subordinated notes with either floating or fixed interest rates.[5] Even though it needs to be understood that uniformed practices is undesired and impossible to enforce (since each covenant package needs to be tailored to a specific loan agreement), it may be stated that efforts resulting in covenants being given too deviating contents due to diligent usage of carve-outs, baskets and

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[4] Barr, Daniel, *Den svenska företagsobligationsmarknaden – en förstudie,* September 2011, p. 6. [cit. Barr].

[5] Compare with the Swedish Securities Dealers Association's template, *Terms and conditions for [Senior Unsecured/Senior Secured/Subordinated] [Fixed/Floating] Rate Notes*, version 1.0, dated 29 May 2013.

general limitations in the clauses' application is detrimental to the investor. In ascertaining whether material differences are at hand, I decided to broadly compare the content of bond terms within the Swedish high-yield bond sector.

1.2 Purpose and theses

Inherent in providing credit is a measure of risk. This must be true, for virtually all loan agreements contain either obligations imposed on the debtor, restrictions imposed on the debtor—or more commonly—the two combined. Only some risks associated with providing credit are mitigated by legislation, for example by providing creditors with insolvency law, as well as the ability to hold security is assets of the debtor with binding proprietary rights. Instead, most risk-mitigating efforts are utilized on a contractual basis, enabling for more flexibility and control.

The aim for this study is to investigate how investors in high-yield bonds use covenants to protect their investment. To answer this question, I will conduct an empirical study aimed to investigate which covenants are most frequently employed in the loan agreements of the bonds within the scope[6]—and then account for their wording (since the value for the investor depends on the wording of each covenant). The results of the analysis of covenant contents will display the practical implications of covenants within the Swedish high-yield bond sector. These practical implications will then be compared with how the same kinds of covenants are used in loan agreements on a more general level, according to literature within financial law. This comparative test will display how well covenants serve their purpose as they are used in the bonds within the scope.

Consequently, this paper will analyse the following question:

How are covenants used in loan agreements of Swedish high-yield bonds, and how well do they serve their intended purpose?

(*Purpose* is understood as meaning to ensure maximum rate of return on the lender's investment as opposed to, *inter alia*, offering the borrower flexibility and rights to self-determination).

In order to analyse this question, I will need to investigate the following issues:

(i) What is the hypothetical purpose behind employing different covenants in loan agreements?
(ii) Does these purposes correspond to the legal implications of each covenant in practice? (Where the legal implication in practice means the wording of each covenant, as identified in the empirical

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[6] See *infra* at section 1.3.

study, subject to my interpretation made in accordance with the parties' will).

(iii) If they do not, which risks are incurred as a result of these deviations in implication, and

(iv) how can these risks be mitigated?

The SSDA benchmark template has been frequently used in the drafting of Swedish high-yield bond terms, displayed by the results of the empirical study. When studying the terms of the template, it is apparent that most areas are covered except for covenants imposed on the borrower (and consequently, what constitutes an event of the default under the notes since this is dependent on which restrictions are in fact imposed). The question that arises is whether it would be possible, or even beneficial, to incorporate covenant features in the standard loan agreement to some or any extent. The paper will provide a brief discussion as regards this subject.

Another reason for me writing this paper is that I wish to learn more about how risk-mitigating efforts are utilized by creditors in loan agreements, both on a general- and specific level—whereas the specific level consists of understanding and accounting for the complicated mechanisms in covenants. For this purpose, the high-yield bond loan agreement is a suitable platform. I also chose this subject due to my interest within the field, and since the phenomenon of high-yield bonds is new in Sweden, meaning that conformed usages of covenant standards have yet to evolve.

Included in the purpose is also my will not only to learn about this topic, but also my desire to shed some light on the high-yield bond as a viable financing option. This is because I believe that efforts will need to be made in the future to improve the transparency and liquidity of the Swedish market, thereby enhancing Swedish non-investment grade corporations' abilities to raise external capital. In light of coming trials, this may be an important aspect of maintaining the competitive edge of our SMEs on a global level. I do not anticipate that this paper will facilitate greatly in achieving this objective, but perhaps it will be of some value to anyone with interest in high-yield bond terms. Moreover, this subject is in parity with my will to write about something that is practically oriented, since I feel that this is a welcome addition to an education with few compulsory practical elements.

1.3 Scope

Whereas there are different kinds of bonds, the base of this study is limited to Swedish high-yield bonds. For the purpose herein, this means:

(i) Bonds that are, or have been, outstanding on the Swedish market, with credit rating lower than investment grade;

(ii) with agent[7];

[7] See *infra* p. 13.

(iii) with first issue date no later than the 30th of October 2013; and
(iv) with terms and conditions available for download via one of the agents' websites.

These delimitation factors narrowed down the scope of the empirical survey to 38 different indentures (as listed under Supplement A).

To the extent possible, I have tried to narrow down the scope of this paper to deal with the contents of the contract that is entered into between the noteholders of a bond, and the issuer. However, the reader will need to have certain knowledge about the theory behind corporate finance to be able to understand the reasons behind taking risk-mitigating measures in credit agreements. As such, the reader will have to bear with some financial paraphernalia.

Reducing the scope further is the limitation in covering legal proceedings following issuers' insolvency. There will only be brief points of contact. The same applies to general aspects of breaches of contract under Swedish law. Moreover, this study will not describe the monitoring role prescribed to the agent or *trustee* of Swedish high-yield bonds. This is mainly because it has already been covered.[8] For the purpose of this paper, the reader only needs to have basic understanding of this role, which, *inter alia*, involves acting on behalf of the bondholder collective against the issuer in situations where breaches of bond terms have occurred, (where the objective is to rationalize monitoring, since it is ineffective for creditors to monitor themselves, and the outsourced monitoring function makes it more attractive for investors to invest), to hold security (if there is any), and represent the noteholders' general interests against the borrower.

There are certain additional factors of risk that investors should bear in mind when it comes to Swedish high-yield bonds, besides those associated with covenants. Albeit it would be a suitable complement to this paper, these risks will not be accounted for since it would make this depiction far too incoherent and drawn-out. In short, these risks consist of certain procedural risks associated with the function of the trustee under Swedish law,[9]

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[8] For example in the master's thesis "*En trustee på den svenska finansmarknaden – problem och framtid"* written by Isac Outinen and Joakim Forsberg (Faculty of Law, University of Stockholm, 2012).

[9] High-yield bond facilities agreements often contain a so-called *no-action-*, or *no-petition clause*. The purpose is to prevent individual noteholders from taking action against the borrower, thus facilitating the trustee's monitoring of the issuer and the latter's abilities to take legal action on behalf of the bondholder collective—without interference from individual noteholders. The validity of these clauses is subject to question, especially as regards if it causes inadmissibility and results in rejection (*sw. avvisning*). Moreover, in light of the "trustee's" legal authorization to act on behalf of the bondholder collective in court, some aspects are questionable. This is since the legal institute is not acknowledged under Swedish law (in jurisdictions where the trust is recognized, the trustee has the ability to take action on behalf of the bondholders on its own account). It is contemplated that the "trustee" under Swedish law will have to take action on the bondholder's account, either by acting in its own name as a party in the proceedings, or in the name of the bondholders via power of attorney from each bondholder (compare with The Swedish Code of Judicial

uncertainties as regards how noteholders in majority can legally bind the minority[10] and concerns associated with exit-consents because of this majority-binding-minority-conundrum.[11]

1.4 Method

I have used several methods during the course of writing this paper. In order to approach the subject of covenant usages on the Swedish high-yield bond market, I examined the terms and conditions of the loan agreements of all of the bonds within the scope. The covenants most frequently occurring were then established. I then examined the wording of each of these covenants if they were part of the facilities agreement of each respective bond. In the matrix created as a result of this research, the key aspects of each covenant's contents were gathered. This method of attaining knowledge about a subject by carrying out observations should appropriately be called empirical.

In the process of making the initial selection of covenants to have as a basis to test against, I consulted practitioners. However, due to the inconclusiveness of interviews for the purpose of methodical and scientific formations of theory, I combined the comprehensions I acquired thereby with my own belief of which covenants should be of importance for investors.

As regards the analytical parts concerning the legal implications of certain covenants, the method that has been applied has been legal dogmatic. I define this method as acquiring all relevant legal information on a subject, in a first step (with relevant sources subject to an internal ranking system; the law is the primary source, followed by preparatory works, case law, and doctrine, in order of relevance). In the second step, the relevant sources are applied to the legal question. This application mainly entails an interpretation of the sources from different perspectives. In the third step, arguments are made as regards the correctness of the selected sources and the accuracy of their interpretation. Since this is a subject including very practical and few scholarly aspects, I have given the term "doctrine" a wide

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Procedure chapter 12, section 2, 13 and 8, as well as chapter 34 section 1. For further reading, see Wieslander, Magnus, *Om avtal om talerätt och taleförbud på företagsobligationsmarknaden i Sverige,* Juridisk Publikation, second issue, 2012.

[10] For further reading, see Wood, Philip, *Law and Practice of International Finance,* University Edition, Thomson Reuters (Professional) UK Ltd., 2008. p. 185 et seq. [cit. Wood.]

[11] Exit consents are universally used in bond restructurings where a debtor wants to change the debt profile, its maturity, or replace expensive debt with cheaper debt. The debtor invites noteholders to exchange the bonds that are held given that they commit to vote in favour of resolutions to amend the debt profile, maturity, etc. If these resolutions are later carried out, minority bondholders who refuse to accept the offer will be left with notes that are worth considerably less than the ones they initially held. Exit consents are therefore perceived as incentivizing noteholders who try to hold out in negotiations. Compare with White & Case, *Bond exit consents: No way out?*, PLC Magazine, Practical Law Publishing Ltd., September 2012.

meaning—thereby including reports and publications of banks, law firms and alike.

1.5 Material

Swedish legal literature has not, to my knowledge, covered any aspects of covenants in loan agreements. In a global perspective, however, relevant literature is not hard to find. By many standards, the work of author Philip Wood is considered to be the benchmark within financial law. His book "Law and Practice of International Finance" has therefore been crucial for this paper. The significance of Wood's doctrine for the sake of Swedish law is questionable at first, but since the law and practice of international finance in Sweden is very much affected by practices in Anglo-Saxon jurisdictions—especially what goes on in London—it becomes significantly more applicable. The object of the book is *"[T]o cover the entire scope of international finance and to do so on a comparative and world-wide basis"*[12]. Moreover, the freedom of contract applies to how loan agreements are drafted. As such, the theory and principles behind covenants and undertakings in international bonds shall also apply on bonds issued in Sweden.

The focus on the work of Wood does inevitably lead to the fact that the objectiveness of this paper may be questioned in light of the lack of the variation in sources. However, since the empirical study and comparison of the facilities agreements will comprise the most important part of this paper, the objectiveness in doctrine is in my opinion not considered a problem.

1.6 Disposition

This paper starts with a theoretical chapter, aimed to provide the reader with background information necessary for understanding why there is a need for credit providers to impose restrictions on the debtor's rights to self-determination. To illustrate, I have compared the rights conferred in creditors in debt with those of shareholders, who are more rigorously protected due to company legislation.

The third chapter will begin with an account for what the literature has to say about covenants in loan agreements. The purpose with the section is to shed light on the underlying purposes behind covenants and the reasons why they are employed. After the general purposes have been established, these will be compared to the results of the empirical study—*i.e.* the covenants' practical implication. The fourth and analytical chapter will drill down into the most apparent and disputable aspects of the difference between covenant usages in theory, and the implication of covenants as they are employed in Swedish high-yield bonds. The results will then be pragmatically summarized in the fifth and last chapter.

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[12] Wood, (preface).

2 The fundamentals of corporate finance

2.1 Introduction

This chapter sets out to explain why credit providers need to impose restrictions on the flexibility of the debtor by incorporating covenants in loan agreements. It is my belief that a brief overview of the reasons behind this is necessary for the reader's understanding of the mechanisms behind covenants. For illustrative purposes, I will approach the subject by having the shareholder acting as a comparison in showing how rights and obligations differ between providers of equity- and debt capital.

To get to the bottom of the topic of protecting provided capital, the reader needs to know what makes the corporate form uniquely attractive when it comes to conducting organized productive activity, and—as a consequence—why it is able to attract different kinds of investments. Bonds are only a part of a major spectrum of ways to raise capital, but the underlying principle is the same as with any investment. You, as an investor, would like to put your capital to use and, as a result, increase its value. In doing this, you probably wish to limit your risks to the extent possible, whilst still maintaining optimal growth capacities for your money. For the corporation that is in need of an influx of cash, the situation ought to be the opposite: to give up as little rights as possible and still keep remuneration levels low.

2.2 The uniqueness of the corporate form

The influx of capital to corporations' financing structures is multi-faceted. Therefore, to understand certain aspects of corporate finance, one needs to have basic knowledge of some key legal features of the corporation. Leading scholars have agreed on five of them: legal personality, limited liability, transferable shares, delegated management under a board structure, and investor ownership. This basic structure is true in practically all economically important jurisdictions across the globe.[13] For the purpose of this paper, three of them are relevant.

2.2.1 Legal personality

A central part of the corporation is that it is a separate legal patrimony. The consequence of this function is dual: it enables for the creation of what is

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[13] Kraakman, Reinier, Armour, John, Davies, Paul, Enriques, Luca, Hansmann, Henry, Hertig, Gerard, Hopt, Klaus, Kanda, Hideki and Rock, Edward, *The Anatomy of Corporate Law – A Comparative and Functional Approach*, second edition, Oxford University Press, 2009, p. 5. [cit. Kraakman et al.].

known as *entity shielding*, and it invokes a barrier of *liquidation protection.* The goal of entity shielding is to protect (or shield), the entity's assets from the creditors of the group entitled to control the firm's assets (effectively, the owners). The firm itself is viewed as the legal owner of these assets. This results in a very important outcome: the right of ownership gives the corporation rights to use the assets, to sell them, and—most importantly—to be able to attach them to its creditors. This also entails that the assets are unapproachable by the creditors of the firms' owners, since they are considered as belonging to the corporation and therefore are unattainable for attachment in any other way.[14]

From a legal point of view, the legal personality-character of the corporation implicates two matters of importance. On the one hand, a priority rule granting the corporation's creditors, as security for its debts, a priority claim on the firm's assets prior to those claims of the personal creditors of the firm's owners.[15] This emphasizes the separated legal personality of the corporation by setting apart assets and, in turn, allows for far more effective monitoring abilities for company creditors.[16] The second part is that of liquidation protection. This attribute provides for a set of rules with the combined target of preventing the dissolution of a firm's going concern value. Thus—by preventing shareholders from withdrawing their shares in the firm at any time—liquidation, either in part or in full, is impossible. Neither can the personal creditors of a shareholder take control of the shareholder's firm assets. Hence, the liquidation protection rule protects the firm's going concern value against both shareholders and creditors of shareholders.[17]

2.2.2 Limited liability

Limited liability means that the liability of any person that invests in a corporation is limited to that of the original stake. If you pay a certain amount for a share, you only risk that amount. If you lend a certain amount, you only risk that amount. Regardless of the corporation's actions, the liability will never exceed that of the original investment. Limited liability is unarguably hugely important. Absent this function, investors would perhaps be forced to supply unlimited amounts of additional capital to struggling businesses. Well-off investors would hesitantly buy shares since all of their personal assets would be risked. To mitigate these risks, it is quite likely that any (wealthy) investor would heavily reduce the number of corporations invested in, and conduct stringent observing of each company's undertakings.[18] This would act detrimental to the abilities for firms to raise capital.

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[14] Kraakman et al., p. 6.
[15] Kraakman et al., p. 7.
[16] Skeel, David A., *Corporate Anatomy Lessons*, Yale Law Journal, May 2004, p. 5. [cit. Skeel.].
[17] Kraakman et al., p. 7.
[18] Easterbrook, Frank H., *Limited Liability and the Corporation,* University of Chicago Law Review, 1985, p. 1 et seq. [cit. Easterbrook].

Henry Hansmann formed the term *owner shielding*, which is what limited liability sometimes is called. Owner shielding is the adverse of entity shielding. It means that creditors only have the ability to make claims towards the firm's assets, and not towards assets held by the shareholders themselves. Owner shielding and entity shielding—together and in conjunction—create *asset partitioning*. The implication is that assets belonging to the firm are pledged as security to firm creditors, whereas business owners' own assets are reserved for their personal creditors.[19]

2.2.3 Investor ownership

Two notable aspects arise out of the term *investor ownership*: the owner's right to control the firm and the owner's right to receive dividends from the corporation's net profit. Controlling rights typically means the right to appoint directors (or remove them), and vote prior to major corporate events. The entitlement to take part of dividends means remuneration derived from firm earnings; typically paid at a certain amount per share. The amount of capital that is contributed to the firm (*i.e.* the amount invested in shares of the company) is in relation to the rights that are given.[20] I think that the term investor ownership exemplifies the difference between investing in equity, compared to debt. Debt investors lack voting rights, and instead this right is conferred by the usage of covenants and other undertakings given by the issuer.

The three characteristics of the corporation discussed directly above are central for understanding corporate finance as a whole. It is *inter alias* due to these elements that debt capital providers wish to employ certain measures to marshal their investment by means of contract. This is where the covenants enter the picture. With that in mind, it is time to broadly approach the topic of firms' business of acquiring long-term financing.

2.3 Capital structures

From a very wide perspective, there are two types of financing options: funds generated by the operations of the company and funds obtained from outside providers. The latter can consist of either equity- or debt capital. A firm's ability to raise capital—equity as well as debt—depends largely upon its profitability. Certainly, there is an ideal capital structure for every business model and every phase of a corporation's growth. For many firms, bank loans may be the single most attractive option. That does not however apply to all. A basic principle is that a portion of equity needs to be incorporated into the financial structure, to make up for increased business risks, thereby catching the effects of unanticipated setbacks of the

[19] Kraakman et al., p. 10.
[20] Kraakman et al., p. 14.

business.[21] Equity is compulsory in a limited liability company's financing structure. Besides the minimal capital requirements stipulated in the *Swedish Companies Act* (SFS 2005:551)[22] (hereinafter referred to as the "Companies Act"), companies also have the ability to emit shares in accordance with the rules set out in Chapter 13 of the Companies Act.

As familiar, a firm is owned by its shareholders. This ownership means entitlement to cash-flow rights, as well as controlling rights.[23] Financing by issuing equity (in excess of the equity raised at the time of the creation of the company) means that the current shareholders' ownership is diluted, thus decreasing their controlling rights. Issuing equity is also reserved for larger corporations with access to the capital markets, and the process is rather expensive.[24] It may also be stated that it is inefficient for a corporation to be financed solely by equity. Dual reasons account for that: the incorporation of debt enables equity holders to leverage their original stake, and more importantly, debt is inexpensive compared to equity.[25] These factors create incentive for corporations to acquire debt.

Different types of debt securities held by an investor can be categorized in several ways. Either, by being recognized by their cash flows, or by defining the rights their holders are conferred with by their respective ownership. Applied to the equity- and debt perspective, the cash flow granted by holding debt is a fixed stream of interest payments, compared to the equity holder's rights to dividends derivative of the company's net earnings. When comparing which rights the securities entitle their holders, shares give the owner appointment- or removal rights, whereas debt gives creditors the power to repossess assets if the debtor fails payment. These rights are of central meaning when it comes to assessing and mitigating the risk of managerial decision-making in self-interest. Shareholders are entitled to dividends due to their ability to vote out directors who do not pay them. Creditors are paid because they have the right to repossess collateral. Absent these rights, investors would reluctantly invest in a corporation. Therefore, their existence is crucial to the influx of capital to businesses.[26]

External capital usually consists of one of two different kinds of bank loans: either a term loan, or a promissory note loan (*sw. reverslån*). A term loan is a loan for a fixed term (or period) that is cancellable only upon the fulfilment of certain specified conditions. Usually, premature payment is only possible if an event of default or certain other events have occurred.

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[21] Credit Suisse, *Mezzanine Finance – A Hybrid Instrument with a Future*, Economic Briefing (no. 42) Zurich, 2005, p. 4. [Cit. Credit Suisse].
[22] Chapter 1, section 5.
[23] Compare with the Swedish Companies Act, *inter alia,* chapter 7, 8 and 18.
[24] Sandström, Torsten, *Svensk aktiebolagsrätt,* fourth edition, Norstedts Juridik AB, 2012, p. 102. [cit. Sandström].
[25] Because the interest paid to service the loan is tax-deductible, compared to dividends that are paid out of taxed income.
[26]La Porta, Rafael, Lopez-de-Silanes, Florencio, Schleifer, Andrei, and Vishny, Robert W, *Law and Finance,* Journal of Political Economy, The University of Chicago, 1998, p. 1113 et seq. [cit. La Porta et al.]

The loan contract is usually very straightforward; the lender advances credit to a debtor, who undertakes to pay it back and in the meantime pay interest at an agreed rate. What tend to complicate things are the rather enormous amounts involved.[27] The other principal form of debt, the promissory note loan, advances to the debtor a sum of money from the creditor, subject to specific terms in the loan agreement that is entered into by the parties involved. The term is not set, but there is usually a final maturity date.[28]

The Companies Act does not interfere with a corporation's ability to acquire capital by lending, as long as the formal decision is made in accordance with the framework of the law.[29] The result of a loan is that a bank that has entered into an agreement with a firm gets a contractual right to its cash-flow (even though the residual cash-flow rights are still left to the shareholder). In order for the bank to try to protect its investment, it is quite likely that it imposes a set of constraints on the firm's actions and undertakings. A comprehensive grid of restraints is however impossible to create; the operating- and investment decisions still lies with the shareholders.[30] There are two main characteristics of a loan: the issuing corporation is required to pay interest on the loan during the time until its maturity, and upon maturity, redeem the principal. The second feature is that the creditor may—in conjunction with other creditors—redeem its claim upon the liquidation or bankruptcy of the debtor. For the shareholder's concern, the situation is quite the opposite. Dividends are only paid when the corporation is profitable (and when the company approves them).[31]

Banks' offering of capital to corporations is regulated in the *Banking and Financing Business Act* (SFS 2004:297).[32] The element of risk associated with providing capital to a business is usually mitigated with the holding of collateral, enabling the creditor to limit his financial exposure towards the debtor by having his debt secured in real assets.[33] As far as the law is concerned, however, no such demand is mandatory. Instead, aforementioned law only requires that *"Before a credit institution decides to grant a loan, it shall assess the risk that the obligations under the loan agreement cannot be performed. The institution may grant a loan only where there exist sound reasons to anticipate that the obligations will be performed."*[34]

Consequently, a loan agreement is not subject to anything but the parties' autonomy as regards requirements for securitization. This entails that it can be negotiated in accordance with the will and negotiating leverage of the parties. Holding collateral offers creditors a sense of security, should the

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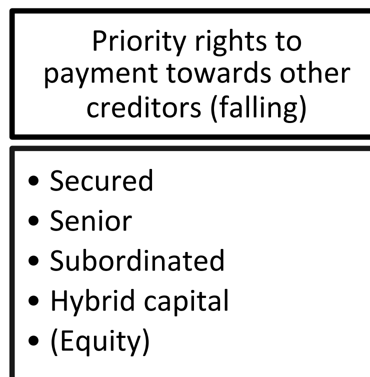
[27] Wood, p. 93.
[28] Lennander, Gertrud, *Kredit och säkerhet*, tenth edition, 2011, p. 19 et seq. [cit. Lennander].
[29] Compare with chapter 8, section 29, 35, 36 and 42 of the Swedish Companies Act (however, consider the indirect effect of the rules in chapter 25).
[30] Since it is the shareholders that control the firm.
[31] Skog, Rolf, *Rodhes Aktiebolagsrätt,* twenty-third issue, 2011, p. 74 et seq. [cit. Skog].
[32] Lennander, p. 13.
[33] Lennander, p. 15 et seq.
[34] Banking and Financing Business Act (SFS 2004:297), chapter 8, section 1.

debtor end up in default. This is because of the primary issue in a bankruptcy that all creditor claims cannot be accommodated. If all creditor claims could be accommodated, the debtor would not have been declared bankrupt to begin with, since then he is not insolvent.[35] After assets that belong to others than the debtor have been separated from the estate and the costs associated with the bankruptcy have been settled, the remainder is to be divided.[36] A fundamental principle in bankruptcy is that all creditors shall have equal right: meaning that they shall be proportionally paid from the remainder of the bankruptcy estate's assets in accordance with the proportion of their claim. This concept is derivative from provisions 1 and 18 of the *Rights of Priority Act* (SFS 1970:979). The principle of equal right is thus not absolute, with the right of priority as an exception. There are two types of priority rights: specific priority rights, for example attached to particular collateral, and general property rights, attached to all the assets in the bankruptcy estate. In short, this means that a creditor who holds collateral in an asset has the ability to get full reimbursement of his claim, derived from the realization of the asset (using the proceeds as payment), prior to other creditors.[37] Hence, the creditor who holds collateral in the asset is *prioritized* against other creditors upon default of the debtor.[38]

Corporations may acquire external capital under specific conditions. For example, a creditor's claim may be designed to provide the creditor with lesser rights, making the loan *subordinated* in relation to other creditors. Such a loan is secondary in right to receive principal as well as interest upon the debtor's liquidation or bankruptcy.[39] The higher the standing, the greater is the opportunity to receive dividends from the allocation of realized values upon the debtor's default.[40] Whereas holding pure equity in a corporation is associated with the highest level of risk, holding secured debt is associated with the lowest. This entails that there is a correlation between risk and reward. Since equity capital is *unsecured,* an investor (shareholder) is generally given the right to vote or rights to receive dividends from the corporation's net profit, as has been discussed. Creditors who provide financing in debt—which is not associated with ownership rights and is *inter alia* negatively affected by the concept of limited liability—have other



Danske Bank, *infra* note 40.

[35] Håstad, Torgny, *Sakrätt avseende lös egendom,* sixth edition 1996, with supplement from March 2000, Norstedts Juridik AB, p. 123. [cit. Håstad].
[36] The Bankruptcy Act chapter 11, section 1.
[37] Håstad, p. 124 et seq.
[38] Lennander p. 78.
[39] Skog, p. 76.
[40] Danske Bank, *Företagsobligationer, En guide till svenska investeringsmöjligheter,* September 2013. p. 7. [cit. Danske Bank].

incentives to put up capital. They are remunerated in interest and may have their loans secured in collateral.[41]

2.3.1 Bonds

In basic jargon, a bond is a tradable debt instrument. It is one of the principal forms of long-term debt, and its issuers range from governments to smaller corporations. The issuer is the debtor, and the holder of the bond is the creditor.[42] The simple difference between a bond and a loan is that the bond is a *tradable* loan. In total, the value of bonds in issue today accounts for about $40 trillion, making the bond market amongst the largest financial markets of the world.[43]

A bond is substantiated by transferable securities that have been issued by a borrower to initial lenders. The first step in the process of issuing a bond is normally carried out by an issuing agent (typically an investment bank) that enters into an agreement with the issuer to procure subscribers for the indenture. This process is managed by circulating a prospectus containing information about the issuer, and the specifics of the bond indenture. The securities are usually listed on a stock exchange, mainly to facilitate investments for companies whose capital placements are limited to those that are listed. As a result, the bonds are easily transferable. The interest rate that the notes carry is either floating, tied to an index, or fixed.[44]

2.3.1.1 What makes a bond high-yield?

The element of risk associated with investing in a bond differs greatly, depending on the results of a combined assessment of the issuing corporation. A key term for investors is yield; the interest a bond will pay as a function of its price. As such, high-yield bonds pay a high interest rate in relation to their market price. The principal reason for a high-yield label is that the issuer's credit rating is below *investment grade* (BB+ or Ba1), which is approximately in the middle of a 22-grade scale, or that the issuer lacks a credit rating altogether. There are three players that dominate the rating sector: Standard & Poor's, Moody's and Fitch. Their concept of rating a corporation's credit worthiness is a process of weighing together the combined risks of the issuers' business, financially as well as commercially. The overall assessment leads to a formal grade. Usually, a line is drawn between bonds that carry the label *investment grade* and the label *high yield*. The assessment is designed to reflect the risk of an issuer's suspension of payment as per the terms of the loan agreement. Standard & Poor's as well as Fitch draw the line at BB+, whereas Moody's call it Ba1.[45]

[41] La Porta et al. p. 1114.
[42] Lennander, p. 100.
[43] Stoakes, Christopher, *Know the City*, first edition, 2013, p. 14 et seq. [cit. Stoakes].
[44] Wood, p. 159 et seq.
[45] Danske Bank, p. 4 et seq.

2.3.1.2 The high-yield bond market in Sweden

The corporate finance market in Sweden has traditionally been highly characterized by the dominant position of traditional bank loans in corporations' financing structures. The main reasons for that include favourable pricing, and firmly established traditions within the Swedish commercial and industrial sphere.[46] Statistics show that as of 2011, roughly 80 per cent. of Swedish corporations relied on traditional bank loans as their method for debt financing. The single most important provider of capital was Swedish credit institutions.[47] Swedish corporations have extended their loan-based financing considerably during the last 15 years, from roughly SEK 1000bn to SEK 2000bn.[48]

Following the wake of the last financial crisis, European companies have started diversifying their debt structures by issuing bonds. This trend has also been apparent in Sweden; many corporations started to show interest in issuing bonds as a complement to more traditional debt a few years back. The year of 2009 showed a high number of Swedish issuances, especially ones denominated in foreign currency. Activity declined during 2010, but outstanding bonds (*i.e.* not only high-yield) by Swedish issuers still amounted to SEK 376bn. According to Bloomberg, about 70 issuers accounted for the total amount of outstanding bonds. Large, often global, corporate groups dominate this market.[49] In 2010, the high-yield issuances by Swedish SMEs with credit ratings below investment grade amounted to only SEK 17,4bn.[50]

The year of 2010 marked the inception of the high-yield bond phenomenon in Sweden. The proposed reasons to the growth that is seen in the segment is that companies see an increase in interest rates on their traditional bank loans, making bonds an attractive financing option.[51] Increased opportunities to raise capital within the high-yield segment is anticipated to lead to more efficient allocation of capital, and better pricing of credit risks—thus allowing for Swedish SMEs to diversify their capital structures.[52] Of further implication is regulatory actions aimed at ensuring banks' solidity and liquidity lurking around the corner. By many, it is believed that this too will lead to a surge in the demand for viable options to more traditional debt financing. It is believed that the high-yield bond will become important to facilitate this demand for corporations lacking abilities to issue investment grade-instruments, and that find additional bank loans

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[46] Gunnarsdottir, Gudrun and Lindh, Sofia, *Marknader för svenska icke-finansiella företags lånebaserade finansiering*, Penning- och valutapolitik, second issue, 2011, p. 31. [cit. Gunnarsdottir, Lindh].

[47] Statistics Sweden (*sv: Statistiska Centralbyrån*), where a "Swedish corporation" is defined as a non-financial corporation conducting business in Sweden.

[48] Barr, p. 5.

[49] Gunnarsdottir, Lindh, p. 34 et seq.

[50] Gunnarsdottir, Lindh, p. 36.

[51] Gunnarsdottir, Lindh, p. 36.

[52] Gunnarsdottir, Lindh, p. 27.

too costly an option (or simply not an option because of lack of collateral to pledge as security, or already too high leverage).

2.4 Regulatory efforts possibly affecting the credit markets

Regulatory efforts are winning ground in light of previous financial crises. It is quite possible that this will result in significant effects on the Swedish bond market.[53]

2.4.1 Basel III

The *Basel III*-regulatory global standard is set to be implemented from 2013 to 2019. The standard entails stricter demands on banks as regards their capitalization and liquidity. The Swedish Central Bank concludes that the implementation of the directive may result in a growth of the high-yield bond market in Sweden, since companies may need to seek additional financiers. Swedish banks should not be affected to a great extent, largely due to their already high levels of capitalization. Foreign banks do nevertheless have a substantial role in about half of the syndicated loans offered to Swedish debtors. If foreign banks are affected by the new directive in a sense that they need to decrease the amount of lent capital to Swedish corporations, such dissension of bank syndicates will result in an increase in interest cost for borrowers. This, combined with the fact that Swedish banks in *that* case may face difficulties putting up more capital will mean that the market may stand before a subsequent change. These facts put together could result in an overall increase of the need to issue high-yield bonds.[54]

2.4.2 MiFID and Solvency II

The European Commission has proposed increased levels of transparency on the market for financial services by harmonizing market regulations. This objective is to be achieved by the implementation of the *Markets in Financial Instruments Directive* (2004/39/EC). It is somewhat expected that these regulations will result in an increased activity on the Swedish bond market, even though opinions differ as regards the presumed positive effects.[55] Moreover, the so-called *Solvency II Directive* (2009/138/EC) may be of interest as well. Aimed at regulating insurance companies' ability to invest in certain assets, the directive will create incentive for insurance companies to invest in bonds with longer maturity. The Solvency II directive carries with it another aspect, namely incentive for insurance companies to diversify their asset stock. This could be achieved by investing in bonds with higher ratios of risk.[56]

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[53] Barr, p. 9.
[54] The Swedish Central Bank, *Finansiell stabilitet*, 2010, second issue, p. 32.
[55] Gunnarsdottir, Lindh, p. 39 et seq.
[56] Barr, p. 9 et seq.

2.5 Closing remarks

During the past few years, the market for bonds issued by Swedish corporations has, as mentioned, grown considerably. This is especially true for the high-yield segment. The market share of the high-yield segment is however quite insignificant in relative numbers and it is investment grade bonds that are prominent in Sweden. Game-changing regulatory actions in the pipeline may however cause material effect as regards the dominance of traditional bank debt in Swedish corporations' balance sheets. This, in turn, will make it harder to attract senior, cheap, capital. The alternative is perhaps the high-yield bond. However, acting detrimental to the attractiveness is naturally the heightened element of risk for the investor due to the nature of these bonds, as aforementioned reasons show. This entails that the covenants given by the lender in the terms and conditions are of great importance; a statement that leads to the next chapter.

3 Covenants generally

3.1 Introduction

One important part of how debt capital providers protect their investment is the covenants made by the issuer in the terms and conditions of the bonds. Whereas the holder of equity shares has the right to control the firm and typically receive the firm's net earnings, the debt capital provider—*i.e.* the lender—, has the same interest in the preservation of capital but possess none of the rights conferred in the equity holder. Debt holders do not have the right to vote, and no entitlement to dividends other than the agreed interest. The "vote" for creditors is therefore incurred by the usage of covenants.[57] This chapter aims to drill down into the concept of the procedure of incorporating covenants in facilities agreements for different reasons. These hypothetical reasons will be compared with the contemplated practical implications, *i.e.* the protective value the covenants offer investors (meaning their intended effect, per their wording, as interpreted in light of the will of the parties, derivative of the results of the empirical study). This method will demonstrate different covenants' value for the investor.

High-yield bond instruments are somewhat renowned for their complex covenant packages. Whereas this may be true, it is still important to appreciate the fact that high-yield bond covenants are typically more functional than those found in senior bank loan agreements. This is due to the origination of the covenant packages used in high-yield bonds. Rather than being *maintenance* based, they are often *incurrence* based.[58] Maintenance covenants are employed to ensure the issuer's on-going and continuous compliance with the terms and conditions, thereby safeguarding the issuer's financial well-being. This is mainly managed by allowing creditors to detect early warning signs of weakening business of the debtor. Maintenance covenants are not typically used in high-yield indentures, and for this there is a reason; if notes are held by a large number of investors, the issuer would be inclined to get all noteholders organized on brief notice to agree on alterations on certain maintenance covenants based on the issuer's financial conditions at the time. Due to the difficulties associated with this process, defaults upon covenant breaches would be frequently occurring.[59] When utilizing incurrence-oriented covenants, many of these problems are effectively avoided. As a result, the issuer is not burdened with covenant breaches beyond its control. Instead, incurrence-based covenants are

[57] Wood, p. 109.

[58] Norton Rose Fulbright, *Accessing the debt capital markets – High yield bonds,* June 2011 [cit. Norton Rose Fulbright.].

[59] Maxwell, William F., and Shenkman, Mark R., *Leveraged Financial Markets: A Comprehensive Guide to High-Yield Bonds, Loans and Other Instruments,* chapter 8; *Bonds Indentures and Bond Characteristics*, by Whelan, William J. III., p. 3. [Cit. Whelan.]. The fact that high-yield bonds less frequently use maintenance covenants was also strongly affirmed by the empirical study.

designed to enable the issuer to test compliance against the covenant's terms *prior* to taking an action. Such action may be incurring additional financial indebtedness, paying dividends or pledging assets as security for indebtedness. If the issuer ends up in a situation where it is necessary to plead with debtors for approving amendments to the covenant terms prior to taking a desired action, it can do so in a rational fashion.[60] Hence, when it comes to high-yield indentures, incurrence covenants are customary whereas maintenance covenants are understandingly more common in bank debt facilities arrangements.[61]

3.2 Covenants in Swedish high-yield bonds

3.2.1 Introduction

To date (October 2013), 38 high-yield bonds[62] have been issued on the Swedish market. I have looked at their respective terms and conditions, thereby concluding which covenants that have been used in each indenture and what their given wording is.

The section below will list all of the covenants that I have investigated in the course of the study. The covenants that are listed have been used in at least one of the bonds of the survey. The summary of the covenants' content in section 3.3 will provide the reader with a bird's eye-perspective of how the parties on the Swedish high-yield bond market utilize covenants. The forthcoming section will provide the reader with a view of the hypothetical purposes behind employing the same covenants. This method clarifies the practical value of these covenants for the sake of investor protection, by exemplifying wordings that may result in ambiguous or undesired applications of the covenants in practice.

Before we discuss the theory and purposes behind covenants, it needs to be clarified what a covenant breach results in—or in other words, the incentive for the issuer to adhere to the terms of the loan agreement. The incentive is rather straightforward; most covenants are designed so that if they are breached, it will cause the issuer to default under the notes. Upon this occurring, the contract usually states that the agent is allowed to accelerate the notes for early repayment.

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[60] Whelan, p. 3 et seq.

[61] Kramer Levin, *Banking and Finance Market Snapshot: A Beginner's Guide to Thinking about Covenants*, December 2006, p. 2. [cit. Kramer Levin]. Also compare with Lucas, Stephen, Ferguson, Robert and Meredith, David of law firm Weil, Gotshal & Manges, *Private Equity Transactions: Selecting Funding Sources*, PLC Magazine, November 2011, p. 4.

[62] See *supra* section 1.3 for the definition of what constitutes a high-yield bond.

3.2.2 The purpose behind employing each covenant

The covenants most frequently occurring throughout my examination of the indentures' terms and conditions are listed below. They are given a general meaning and purpose, in light of their role in loan agreements and derivative of relevant literature. The actual results of the empirical survey, *i.e.* the contents of the covenants in the indentures, will be presented under section 3.3.

The purpose behind each covenant will now follow. Covenants that are simple in nature will only be briefly explained, since these covenants usually only serve a purpose with very limited scope.

Negative pledge

A negative pledge-covenant aims to prevent the borrower from creating any security upon any of its assets. The covenant is imperative in loan agreements, and the reason behind employing the clause has a lot to do with priority rights in bankruptcy.[63] Absent this covenant, an act where the issuer grants security over any of its assets in favour of *an outside* creditor results in subordinating the initial noteholders' unsecured claim, and, in turn, makes any pari passu-warranties of the issuer lose its effect.[64] Before going further with negative pledges, something needs to be said about how a bond's legal status is affirmed by invoking pari passu-clauses. A pari passu-clause usually states that *"The bonds are unsecured obligations of the issuer and rank at least pari passu, without any preference amongst themselves, with all other outstanding, unsecured and unsubordinated obligations of the issuer, present and future."*[65] As stated, the clause is utilized to affirm the legal position of the notes—in particular the mandatory ranking of debt where there is competition within the creditor collective. A pari passu-clause is normally not seen as a covenant, rather a warranty. The purpose is not to ensure that the issuer will pay all outstanding debts on a pro rata-basis upon insolvency (since that would entail the debtor would have to pay *all* debts pro rata—including the utility bill). Instead, the clause declares legal ranking, not legal equal payment.[66]

Continuing with the negative pledge-covenant, it may be stated that it is advantageous in situations where the borrower ends up in financial distress and is unable to acquire additional indebtedness unless it is secured in real assets; a situation which the negative pledge-covenant prevents from taking place. Moreover, negative pledge-covenants are important for the purpose of secured indentures as well. In this case, it will avert complications occurring due to the creation of secondary priority rights held in an asset that is

[63] Compare with *supra* p. 21.
[64] Wood p. 111 et seq.
[65] Wood, p. 163.
[66] Wood, p. 118.

formerly pledged. Negative pledge-covenants also safeguards the interest of secured creditors by allotting both asset value as well as therein generated cash flow to the secured creditor, thereby giving the secured creditor more influence in a work-out or reorganisation.[67]

No disposals

A "no-disposal"-covenant sets out to establish that the issuer shall not be permitted to dispose of its assets with the main subject to transfer value to certain parties, detrimental to the position of the bondholders. A covenant with the purpose of restricting the issuer's disposal rights to company assets has several reasons behind it. Predominantly, to prevent for the stripping of assets of the issuer by sales on credit to another (perhaps associated) corporation, resulting in key assets of the issuing corporation being turned to a claim on a possibly worthless one. Such conduct could result in unwanted changes of the business, which the bondholders certainly wish to prevent. Of additional importance is the restriction on the issuer's right to dispose of company assets by realizing their value in order to pay off other creditors in case of financial difficulties. This conduct shifts the natural equality of treatment of the creditor collective (if the creditors are all unsubordinated and ranking pari passu), which is not in the interest of the creditors not benefitting from the restricted disposal.[68]

Restrictions on disposal rights are often made to include any intra-group disposals. This is a concern for any creditor whose claim is towards the parent company (the issuer), not against a subsidiary of the issuer. Regardless of the intra-group character of the disposal, the result is still that the creditor is given an undesired commercial subordination.

For the sake of allowing the issuer to maintain a level of control over its business, several exceptions to the restrictions are often granted. Examples of such exclusions include the right to dispose of company assets as long as it is in the ordinary course of the issuer's business, leases (both operational and in the ordinary course of business), up to a specified basket amount, disposal of assets that are either obsolete or that are replaced with equal assets, and certain disposals where the net proceeds of such disposal is used to repay certain outstanding debt.[69]

No distributions

"No-distribution"-covenants sets out certain limitations in the issuer's distribution rights of company assets. These constraints are likewise common in bond terms. Specifically, this covenant concerns dividends and distributions of shares. The reasons behind no distribution-covenants are to make sure that creditors receive payment prior to shareholders. These restrictions are typically not found in bond issues where the debtor is a

[67] Wood, p. 111 et seq.
[68] Wood, p. 120 et seq.
[69] Wood, p. 121 et seq.

publicly listed company, rather when it is a smaller, private corporation with a limited shareholder base.[70] The restrictions in distribution rights are designed to guard the bondholders' rights by imposing limitations on asset classes that rank below the notes in the issuer's capital structure. It is nevertheless not uncommon that exceptions to the right to distribute assets are included in the covenant terms. For example, if such constrained distributions in aggregate amount to less than a certain percentage of proceeds derivative of a sale, or in relation to specified financial ratios.[71]

Together, the two covenants above aim to restrict payments; *i.e.* what the issuer is permitted to do with cash and assets generated from different activities of the business, whether generated from operations or sales of company assets. The noteholders wish to create a snare around these values, and allow them out of the sphere of the group only under a limited set of circumstances. Hence, if the borrower decides to make a payment, it needs to test it against the applicable covenant aiming to restrict these types of payments so that it does not cause a covenant breach and subsequent acceleration of the notes. This ought to provide for a strong enough incentive not to make restricted payments that benefits only certain (perhaps junior) claimants.[72]

Change of control

Change of control-covenants protect creditors from presumed negative effects associated with alterations in the shareholding structure of the issuer. The clause is intended to allow the holder of the notes to reassess the investment in the debtor upon ensuing changes in ownership. Given that the issuer is not publicly traded, a change of control-event is often seen as occurring upon the cessation of ownership in the issuer by shareholders defined as *permitted holders*. These key individuals will usually be demanded to own, at any time, a majority of the outstanding shares of the issuer. The thinking behind this idea is that the noteholders made an investment decision upon the value added by the present shareholder structure, thus, upon a breach in this structure, their position is deemed to be negatively affected.[73]

Usually, the breach will vest the bondholders with a right to demand the issuers' unconditional payment of 101 per cent. of the nominal amount of the outstanding bonds. The reason is simple; should the investor wish to exit the investment due to the changed ownership, it may not be possible to trade the notes on the open market with satisfactory result due to value depreciation (since the market too may believe that the parting shareholders added value to the corporation). The issuer is instead forced to repurchase

[70] Wood, p. 124.
[71] Norton Rose Fulbright.
[72] Whelan, p. 6 et seq.
[73] Whelan, p. 5.

the notes at a premium, thereby decreasing incentives to allow for change of control-events to take place.[74]

No New Financial Indebtedness

This is a basic and fundamental debt covenant. Its objective is to ensure that a minimum level of financial strength is maintained by imposing restraints on the issuer's ability to incur further debt obligations. Most debt covenants does however provide the issuer with the ability to incur what is defined as *permitted debt*. Permitted debt is often possible to incur regardless of the satisfaction of certain debt ratios. Standard exceptions could be existing bank debt, debt that is acquired in the ordinary course of the issuer's business, or in accordance with certain basket limitations.[75]

Cross-acceleration or cross-default

These covenants share a common objective and mechanism, but differ slightly in how they work. The cross-acceleration covenant is a covenant that operates by defaulting the issuer under one agreement, when the issuer has defaulted under another agreement, and the creditors under the latter agreement have accelerated payment. The effect is, in short, that the creditors under one loan agreement benefits from default provisions under a completely different agreement. The cross-default covenant, on the other hand, leads to an automatic event of default under one agreement, if the issuer defaults under another agreement, irrespective of if the creditors under the second agreement accelerate payment.[76]

Loan to Value ("LTV")

This is a covenant that is used to measure the value of a loan compared to the market value of a certain asset, or a pool of net assets.[77]

Interest Coverage Ratio

This covenant employs a ratio determining the ability of the issuer to pay its interest costs. The ratio is typically calculated by dividing the issuer's EBIT[78] or EBITDA[79] with the interest costs incurred over the same period. This covenant is sometimes also called "Earnings to Interest Ratio". The purpose is however the same, and the use of this covenant is typically very frequent. The aim is to test the issuer's ability to pay interest on outstanding debt by ensuring that there are sufficient amounts of cash at hand for servicing it.[80]

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[74] Whelan, p. 5.
[75] Norton Rose Fulbright.
[76] Practical Law, Glossary Item (http://uk.practicallaw.com/resource/3-382-3376)
[77] Compare with Investopedia article *Loan-to-Value Ratio – LTV Ratio* (http://www.investopedia.com/terms/l/loantovalue.asp).
[78] Earnings before interest and taxes.
[79] Earnings before interest, taxes, depreciation and amortization.
[80] Wood, p. 123.

"Minimum Equity", "Minimum Cash" and "Equity Ratio"

These financial covenants demand that the issuer—at all times or at given test periods—shall have a minimum amount of equity and/or cash available, expressed in real numbers. The equity ratio, on the other hand, means that the borrower shall have a minimum ratio of shareholder's equity; the amount shareholders would receive upon liquidation of the issuer. The ratio is recognized by calculating the issuer's total assets (as defined in the definitions of the terms) with the total shareholder's equity.

Debt to EBITDA Ratio

This is a covenant that measures leverage, by calculating the issuer's debts (or net debts) divided by its EBITDA. The ratio is constructed to display the number of years it would take for the issuer to re-pay its debt if net debt and EBITDA figures remain the same. The overall purpose is to restrict the issuer taking up too much debt, detrimental to the solvency of the corporation.[81]

Capital Coverage Ratio

This covenant means, in outline, the result acquired when dividing the borrower's tier 1 capital with its tier 2 capital. The ratio is engaged to shield investors by expressing a debtor's exposures towards risk-weighted credit.[82]

Listing requirements

This means a demand from the bondholders that the issuer will list the bonds on a regulated marketplace. This is, as we have learnt, important since many investors are not allowed to invest in instruments that are not publicly traded.

Financial statements

This covenant enacts a requirement on the issuer to present to the bondholder its financial statements. Typically, this is required on a semi-annual or quarterly basis, with the variations typically tied to the credit quality of the issuing corporation.[83]

Compliance Certificate

A compliance certificate is a certificate given in conjunction with financial statements reported by the issuer to the creditors under the terms of the facilities agreement. The clause is rather forthright. It is employed to facilitate for monitoring of the loan terms, examining the financial health of

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[81] Wood, p. 124.
[82] Compare with Investopedia Article "*Capital Adequacy Ratio – CAR*" http://www.investopedia.com/terms/c/capitaladequacyratio.asp.
[83] Norton Rose Fulbright.

the issuer, as well as checking for potential defaults under certain provisions.[84]

3.3 The results of the empirical research: how are covenants used in practice?

In the beginning of each sub-section, an example of a covenant of one indenture will be listed. It is my ambition that this will facilitate the reader's understanding of the covenants from a practical perspective. Following each example will be an account for the results of the empirical study: the ascribed wording of each covenant as it has been drafted in the terms and conditions of each bond. This method will demonstrate the patterns that have appeared throughout the course of the study.

The methodology used for acknowledging the results of the empirical study will mainly consist of listing exceptions to the applicable covenant, to illustrate how the constructions and mechanisms are specifically tailored to the business of the issuer—in turn leading to great variances of how the same type of covenant is applied in different indentures. The complicated nature of many of these covenants results in several impediments regarding the homogeneousness of how it is possible to present the data of the study. It is quite simply impossible to get an adequate overview of the content of covenants without reducing and rationalizing the content of covenants into a more undeviating form. Therefore, I have eliminated covenant contents that I have deemed to be:

(i) Too specific to the issuer, thus not applicable in a general perspective; and
(ii) contents that are obvious for any loan agreement.

These exceptions will, for the reasons above, not be listed.

The reader needs to be aware of this fact when studying the data below, since no data is fully comprehensive and the deletion of data has been subject to my own subjective opinion of what fits under (i) and (ii) above.

Some covenants are cited directly from the applicable terms and conditions, some have been altered slightly due to their sometimes very specific content.

3.3.1 Negative pledge

The negative pledge-clause is by many standards one of the most important instruments in a loan agreement. The text below exemplifies the rigorous structure of how a typical clause may be composed in a high-yield bond facility agreement:

[84] Wood, p. 111.

"*The Issuer shall not, and shall procure that none of its Subsidiaries, create or permit to subsist any Security over any of its assets, unless such security is Permitted Security.*

Where "Permitted Security" means any guarantee or security: (a) arising by operation of law (including collateral or retention of title arrangements in connection with Advance Purchase Agreements but, for the avoidance of doubt, not including guarantees or security in respect of any monies borrowed or raised); (b) provided in relation to any lease agreement (hyresavtal) entered into by a Group Company in the ordinary course of business; (c) provided in relation to any Bank Loan constituting Permitted Debt; (d) comprising counter-indemnity obligations under any bank guarantees or letters of credit issued by a bank or financial institution and drawings under any such bank guarantees or letters of credit, which in each case is provided in the ordinary course of business in relation to customers, other business partners, governmental bodies or authorities on terms and conditions customary for counter-indemnity obligations; or (e) comprising parent company guarantees in relation to Subsidiary undertakings under customer contracts incurred in the Ordinary course of business.

Where "Permitted debt" means any Financial Indebtedness: (a) related to any Group Company's lease agreements (hyresavtal) or finance leases, provided that such Financial Indebtedness is incurred in the ordinary course of such Group Company's business and, as regards finance leases, in an aggregate maximum amount not, at any time, exceeding SEK 30,000,000; (b) taken up from a Group Company; (c) incurred by the Issuer or any Group Company under Bank Loans; (d) arising under a derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price where such exposure arises in the ordinary course of business or in respect of payments to be made under the Finance Documents, but not a derivative transaction for investment or speculative purposes; (e) incurred as a result of any Group Company acquiring another entity and which is due to that such acquired entity holds indebtedness; (f) incurred in the ordinary course of business under Advance Purchase Agreements; (g) incurred under any counter-indemnity obligation having the effect of Financial Indebtedness incurred in the ordinary course of business and constituting Permitted Security; or (h) incurred by the Issuer in relation to any Market Loans, provided that such Market Loans ranks pari passu or is subordinated to the obligations of the issuer under the Finance Documents, and has a final redemption date which occurs after the Final Redemption Date; and

where "Bank loan" means means any existing loans incurred by the Issuer or any Group Company in relation to Swedbank AB (publ), or any future loan incurred by the Issuer or any Group Company in relation to any reputable bank."[85]

[85] Terms and Conditions for Opus Group AB's (publ) maximum SEK 200 000 000 senior unsecured floating rate notes, ISIN SE0005466034.

Negative pledge-covenants were used in all indentures but seven, making it one of the most frequently used covenants within the scope. Major differences were identified as regards the given wording, with certain apparent patterns. As for permitted guarantees and/or securities, the most common exceptions to the negative pledge provisions were guarantees or securities provided in relation to any:

- Lease agreements;
- loans in the ordinary course of the issuer's business or trading;
- working capital facilities;
- overdraft credit facilities;
- advance purchase agreements;
- security provided to a specific entity or fund;
- shares in subsidiaries; and
- under a basket (where amounts were either expressed in in real numbers, or as a percentage of certain financial indicators).

As expected, the value of the negative pledge covenant for the high-yield noteholder is decreased significantly upon deviance from its default wording. If the debtor is allowed to create security upon its assets for the purpose of raising additional debt, bondholders may face a situation where they will be worse off than anticipated, should the debtor default. This is because whoever has been granted a security or guarantee will rank senior to the noteholders if the noteholders are unsecured. If noteholders are secured, and security has been granted to an outside party, the value of the noteholders' security may be reduced. Hence, it may be asserted that negative-pledge clauses offer great value for the investor in their default form. Likewise, however, it may be asserted that this value fluctuates depending on which exceptions are granted.

Investors should, according to me, look out for negative pledge-covenants that permit the issuer to provide security for indebtedness up to a specified amount that is too high, *i.e.* basket volumes that are far too generous. Investors should also be concerned if securities may be provided to certain specific entities (a bank, for example)—especially if there is no adequate basket limiter that kicks in. Moreover, investors should look out if the issuer is permitted to create security upon its assets benefitting creditors under an initial senior bank debt, subject to an increase of the debt by a certain percentage. Furthermore, there is a trade-off situation that needs to be taken into calculation when assessing the negative effects of having exceptions to negative pledge-covenants that may be believed to be necessary to ensure that the borrower can conduct its day-to-day business in a flexible yet controlled manner. Herein lies the issuer's ability to create security upon its assets for the benefit of loans in the ordinary course of business, as well as with working capital- and overdraft credit facilities. These carve-outs should to some extent be permitted to ensure that the issuer can maintain its daily operations. It is however essential that the basket amount is kept fairly low to ensure that this option is not misused.

To conclude the implications of negative pledge-covenants in practice, a few matters stand out as being of significance. Given the rarity of comprehensive negative pledges (*i.e.* completely restricting the borrower's ability to create security over its assets), issuers and investors alike understand the necessity to have certain abilities to incur secured asset funding. However, negative pledge-clauses are employed very frequently across the scope of the study, it tells us that investors believe the covenant to be important for their protection. This leads us to an interesting predicament: notwithstanding wordings, does negative pledge-covenants serve their intended purpose under Swedish law? Specifically, the question revolves around the clauses' contemplated effect on a third party, *i.e.* a person outside of the contractual relationship between noteholder and issuer that accepts security in an asset in conflict with the agreement entered into between the initial borrower and the initial lender. Because of the indicated significance of negative pledges, and the possible divergence between the purpose and practical implication, this is a question that will be thoroughly covered in the coming chapter.

3.3.2 No disposals

No disposal-clauses and no distribution-clauses share a common objective: to keep values within the issuer, and/or within the issuer group. As the exemplifying illustrations below enlightens, these covenants are subject to rather complex mechanisms of carve-outs:

"*(a) The Issuer shall not, and shall procure that no Material Group Company, make(s) a Restricted Disposal, unless such disposal is carried out at fair market value and on terms and conditions customary for such transaction and provided that it does not have a Material Adverse Effect. The Issuer shall promptly notify the Agent and the Bondholders of any Restricted Disposal and, upon request by the Agent, provide the Agent with any information relating to the transaction which the Agent deems necessary (acting reasonably).*

(b) Notwithstanding paragraph (a) above, the Issuer may not sell or otherwise dispose of shares in any Guarantor.

a Restricted Disposal means:

a sale or otherwise disposal of shares in any Material Group Company or of all or substantially all of the Issuer's or any Material Group Company's assets, or operations to any person not being the Issuer or any of its wholly-owned Subsidiaries." [86]

The empirical study showed uniform usages of no disposal-covenants. At first glance, clauses seem to offer rigid protection for the investors. The

[86] Terms and conditions for ÅR Packaging Group AB's (publ) maximum EUR 115 000 000 bonds, ISIN SE0005224029.

implication does however seem converse when studying contents more closely. I conclude that the risks herein lie in the frequent use of vague terms, such as *material adverse effect* and *arm's length terms* (and to some extent, *fair market value* even though this should be easier to define).

Most frequent is the practice of *fair market value*, used in 14 out of 25 bonds that employed the no-disposal-covenant. *Material adverse effect* was used in 9/25 bonds, and *arm's length terms* in 5/25.

In light of this data, is it possible to satisfactory answer the question whether the purpose to prevent the issuer from disposing of company assets differs from how the covenant is employed, given that these terminologies are used? The short answer to this question is that it is not. The long answer is that whereas theory and practice may be comparable, it is not possible to engage in answering the question without agreeable definitions of each term, or viable arguments as to the necessity to incorporate normative functions as instruments for settlement. This brings about a challenging discussion, which too will be covered in the coming chapter.

3.3.3 No distributions

With no distributions-covenants, appeared discrepancies between theory and practice finally seem to ease—at least on a more general level. The study did however display a very dense use of carve-outs, which of course enables the borrower more freedom to act in its own self-interest.

"(a) The Issuer shall not, and shall procure that none of its Subsidiaries will:

> *(i) pay any dividend on its shares (other than loans and group contributions to the Issuer or a Subsidiary of the Issuer);*
> *(ii) repurchase any of its own shares;*
> *(iii) redeem its share capital or other restricted equity with repayment to shareholders;*
> *(iv) grant any loans (other than to the Issuer or a wholly owned Subsidiary of the Issuer); or*
> *(v) make any other similar distribution or transfers of value to the direct or indirect shareholder of the Issuer, or any Affiliates of the Issuer (other than the Issuer or another Subsidiary of the Issuer).*

(b) Notwithstanding paragraph (a) above, the Issuer may distribute fifty (50) per cent. of the Net Disposal Proceeds upon a Disposal of assets in accordance with Clause […] (Disposal of Assets) below, if at the time of the payment:

> *(i) no Event of Default is continuing; and*

(ii) the Incurrence Test is met (calculated on a pro forma basis including the relevant distribution)."[87]

Carve-outs to restrictions imposed on the borrower were used comprehensively, though with surprising levels of uniformity. Only 6/39 bonds lacked the covenant entirely. The wording of the covenants that were employed each specified what constitutes a restricted distribution. Principally, contents corresponded well to that of the example closed disclosed above, as regards section (a), subsection (i)-(iii). Distinctiveness varied considerably more as regards subsection (b), (and its counterparties in other terms and conditions setting out the scope of the applicable covenant)—with patterns being recognized either in usage of financial indicators expressed in percentages, or in real numbers.

Regardless of the vast usage of exceptions to restricted distributions, I conclude that the effects of this clause are far more foreseeable and well-defined in nature. One notable aspect is that this covenant displayed such uniformed wordings that it may perhaps even be contemplated that it could be incorporated in some form in the SSDA's standardized loan agreement (with abilities to individualize certain aspects, such as under (b)).

3.3.4 Change of control

A change of control-provision shares the objective to keep values within the issuer with the two covenants above. The value here is however tied to human capital, rather than monetary.

"Change of control means:

(i) the occurrence of an event or series of events whereby one or more Persons, not being [...] (or an Affiliate of [...], acting in concert, control shares in the Issuer representing more than 30 per cent. of the votes in the Issuer or otherwise gain direct or indirect control of the issuer;
(ii) the shares in the Issuer ceasing to be listed on NASDAQ OMX Stockholm; or
(iii) the sale of all or substantially all of the assets of the Group whether in a single transaction or a series of related transactions.

whereas "control" means the power (whether by way of ownership of shares, proxy, contract, agency or otherwise) to:

(i) appoint or remove all, or the majority, of the directors or other equivalent officers of [the issuer]; or

[87] Terms and conditions for ÅR Packaging Group AB's (publ) maximum EUR 115 000 000 bonds, ISIN SE0005224029.

(ii) *give directions with respect to the operating and financial policies of [the issuer] with which the directors or other equivalent officers of [the issuer] are obliged to comply, and "acting in concert" means a group of persons who, pursuant to an agreement or understanding (whether formal or informal), actively co-operate, through the acquisition directly or indirectly of shares in the Issuer by any of them, either directly or indirectly, to obtain or consolidate control of the Issuer."*[88]

Two materially opposing approaches to change of control-clauses were identified; either, upon the cessation of ownership of certain defined individuals, or upon the gain of control of (typically more than fifty per cent.) by certain defined individuals. Variations of percentage limitations as to when *control* is considered to have taken place were also identified. The majority of the bond terms specified that a change of control event occurs if any person or persons—acting in concert, directly or indirectly—acquire more than fifty per cent. of the shares in the issuer. To some extent, there were exceptions to the limitation insofar as certain entities or persons were allowed to hold more than fifty per cent.

However, certain other practices entailing a change of control-event were identified:

- If the issuer ceases to be a subsidiary of a specified parent;
- if a person or several persons acquire control of appointment rights, *i.e.* the right to appoint or remove the majority of the board of directors;
- controlling of shares representing 30 per cent. of the votes in the issuer;
- if certain individuals—directly or indirectly—cease to own and control at least 51 per cent. of the votes and shares of the issuer;
- at the occurrence of an IPO (initial public offering);
- delisting of the shares of the issuer on a regulated market;
- if the main shareholder ceases to control the issuer;
- the occurrence of an event or series of events whereby a person not being the main shareholder, or an affiliate of the main shareholder, acquire control of the issuer; and
- if a certain entity ceases to own twenty per cent. of the shares of the issuer, or if any person or entity, acting in concert, becomes the largest shareholder in the issuer, or if any person or entity, acting in concert, acquires control of more than thirty per-cent of the shares of the issuer;

The benchmark outcome of a change of control-event—known as a put option—was early redemption of the outstanding notes at an amount corresponding to 101 per cent. of the nominal amount of the bonds.

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[88] Terms and Conditions for Cloetta AB's (publ) Senior Secured Callable Floating Rate Notes, ISIN SE0005364437.

The study clearly showed that change of control-covenants are believed to offer investors protection against detrimental changes in ownership of the issuing corporation since they were frequently used. Only four out of 38 indentures lacked a change of control-provision of some dignity. The aspect that is of interest when looking at the covenants is the mechanisms used to establish whether a change of control-event has occurred or not. This brings about an interesting discussion as regards a feature known as *portability.* The term refers to approaches developed to allow for acquisitions to takes place, absent a requisite for a change of control-offer. An effective remedy lies in expanding the definition of permitted holders, as illustrated in a noted high-yield bond issued by the British privately held insurance company Hastings Insurance Group (Finance) PLC ("Hastings").[89] A distinguished aspect of the change of control-provision in Hastings is its wide definition of permitted holders. This has material effect on when the provision is triggered, and therefore, when a change of control-redemption—which is fundamentally important for investor protection purposes—may occur.[90]

In the Hastings case, the permitted holders consisted of the corporation's initial investors and their related parties. The initial investors were, *inter alios*, certain named management investors, as well as the sponsors. What stands out in Hastings is the definition of sponsors, being extraordinarily wide. Amongst others, the investment bank Goldman Sachs Group Inc., ("GS") was one. The definition included GS' affiliates, any partnership where an affiliate is a general partner, as well as any fund managed, advised, sponsored or owned by any of the two aforementioned. All of these parties were struck by the permitted holders definition, at the date where the acquisition was completed. Moreover, a shareholder, a member or partner of either a partnership where an affiliate of GS is a general partner or a fund managed, advised, sponsored or owned in accordance with the above, was also included in the list of permitted holders. This ending statement is important since it hypothetically means that GS' financial exposure, *i.e.* deal participation, could be heavily reduced due to the lack of requirement to hold a minimum amount of shares in the issuing corporation.[91] If an investor decided to buy the notes because of GS' good name attached to the issuer, they could find themselves very mislead.

If this way of drafting change of control-clauses would win ground in Swedish high-yield indentures, investors should approach them with caution given that an investment decision has been made upon the value added by the current ownership structure. Investors should in that case try to invoke a definition of permitted holders with clear-cut limitations, thus forbidding initial investors to reduce their equity by selling shares in the issuer to parties remotely related to them. In sum, such deviating aspects identified as risks in accordance with the above were hardly identified in the empirical

[89] Debt Xplained, *Hastings – Portability by Novel Means,* October 2013, p. 1. [cit. Debt Xplained].
[90] Debt Xplained, p. 2.
[91] Debt Xplained, p. 2 et seq.

study. But, due to the levels of criticism that may be appointed to such executed clauses as the one in the Hastings's case, investors should keep an open eye as to the definition of key individuals' affiliates and alike to counteract similar behaviour in Swedish indentures.

3.3.5 No new financial indebtedness

This clause is employed to ensure that the issuer's cash flow is designated to service the noteholders' loan, and not other debt obligations. The empirical study showed, besides countless carve-outs permitting the raising of new financial indebtedness, that issuers were repeatedly permitted to incur new indebtedness that has a maturity date *after* the outstanding notes. In addition, it was often specified that the new financial indebtedness should never have higher priority than the notes, for the very same reason.

"The Issuer shall not, and shall procure that none of its Subsidiaries, incur any additional Financial Indebtedness or maintain any existing Financial Indebtedness, provided however that the Issuer and the Subsidiaries have a right to incur and maintain Financial Indebtedness that constitute Permitted Debt.

where "Permitted Debt" means debt (a) related to any Group Company's lease agreements (Sw. hyresavral) provided that such Financial Indebtedness is incurred in the ordinary course of such Group Company's business; (b) related to any Group Company's finance leases, provided that such Financial Indebtedness is incurred in the ordinary course of such Group Company's business and in an aggregate maximum amount not, at any time, exceeding SEK 2,000,000; (c) taken up from a Group Company; (d) related to any Shareholder Loans; (e) arising under a derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price where such exposure arises in the ordinary course of business or in respect of payments to be made under the Terms and Conditions, but not a derivative transaction for investment or speculative purposes; (f) incurred in the ordinary course of business under Advance Purchase Agreements; (g) incurred by the Issuer if such Financial Indebtedness meets the Incurrence Test tested pro forma including such incurrence, and (i) is incurred as a result of Subsequent Bond Issue, or (ii) ranks pari passu or is subordinated to the obligations of the Issuer under the Terms and Conditions and the Agent Agreement, and has a final redemption date or, when applicable, early redemption dates or instalment dates which occur after the Final Redemption Date; (h) incurred under any counter-indemnity obligation having the effect of Financial Indebtedness incurred in the ordinary course of business and constituting Permitted Security; or (i) not permitted by (a)-(i) above, and related to (one or several) credit and guarantee facilities for guarantee and working capital purposes, in an aggregate maximum amount not exceeding SEK 75,000,000, and where a maximum of SEK 25,000,000 can be utilized for working

capital purposes and where the working capital part of the facility shall be undrawn at the Issue Date (the "Revolving Credit Facility")."[92]

The study showed very deviating usages of this covenant. Even though the purpose is to keep value inside the corporation by not having competing destinations for the borrower's cash-flow (for loan servicing), the purpose is likewise to ensure that no additional creditors are allowed to enter the capital structure of the issuer. This is true both as regards maintaining a pari passu structure amongst all unsecured creditors, and ensuring that no creditors with priority rights are let in. Hence, the investor should ensure that the issuer is not allowed to incur additional financial indebtedness, unless it is provided that:

(i) It ranks pari passu or is subordinated to the noteholders' claim; and
(ii) that cash-flow does not need to compete when it comes to repayment of the principal; meaning that the final maturity date of *additional* indebtedness should be (long) after the noteholders'.

Of substantial importance for these purposes is the magnitude of the carve-outs, but also the basket amount. If this is too great, the issuer is permitted to incur indebtedness regardless if not in accordance with (i) and (ii) above. The study displayed basket amounts of varying distinction, expressed either in real numbers or as a percentage of financial indicators. What stood out as interesting according to the empirical study was the proportion of the basket amount in relation to volume circulating of the notes. In average, the "no new financial indebtedness"-basket spanned from—in applicable cases and subject to conditions such as that new indebtedness may never rank higher than the outstanding notes—95 per cent. to 1 per cent. of the volume circulating (with an average of 17 per cent.).

Other permitted financial indebtedness included financial indebtedness:

- For currency hedging purposes;
- under working capital facilities and advance purchase agreements;
- in the ordinary course of business;
- that is intra-group (meaning indebtedness owed to a group company);
- lease agreements or finance leases;
- owed to a specified bank, fund or entity; and
- subject to incurrence tests of varying nature.

It may be asserted that basket limitations' importance increases crucially when usage of exceptions to covenants is extensive, thus making up for problems related to ascertaining the legal value of the covenant. In this context, the basket amount acts as a final frontier. In parity with prior

[92] Terms and Conditions for Etravelli AB (publ) maximum EUR 120 000 000 senior callable floating rate notes, with ISIN SE0005393220.

conclusions, this covenant also has to provide the borrower with flexibility to manoeuvre whilst still fulfilling its objectives. Permitting a basket amount of great value may however not be necessary; on the contrary, I think it should be refrained from by any investor if the matter is not a deal-breaker in the negotiations of the terms and conditions.

3.3.6 Cross-acceleration and cross-default

Most sizable corporations today are heavily dependent on external funding. As a result, they may have several unresolved credits obtained from different providers. These loans are varying in proportion, priority and duration. This is a risk for additional creditors (especially ones that are low in the food chain of priority rights), but also an opportunity that should be seized, in a sense that it can be utilized to create an additional safety net for the noteholders.

"The Agent is entitled, on behalf of the Holders, to declare all but not only some of the Bonds due for payment immediately or at such later date as the Agent determines (such later date not being a date falling later than […] [(…)] Banking Days from the date on which the Agent made such declaration), if: the Company or a Group Company does not pay when due any payment or otherwise fails to fulfil the terms and conditions under any Financial Indebtedness granted to the Company or a Group Company and such Financial Indebtedness due to the failure to pay has been accelerated for payment or could have been accelerated, or if the Financial Indebtedness could not be accelerated or if the outstanding payment was the last payment under the Financial Indebtedness, if the failure to pay has been continuing for at least […] [(…)] Banking Days, where the aggregate outstanding and unpaid Financial Indebtedness in question amounts to at least SEK […] (or the equivalent thereof in other currencies)."[93]

Covenants regarding events of cross-default and cross-acceleration aim to cover the customary spectrum of possible default scenarios, thereby increasing the safety net of the bondholders by expanding the scope under which the outstanding notes may be accelerated. As a result, if the issuer (or any group company, typically) is unable to pay its debts or generally suspends any of its payments, the notes under the bond may be declared payable. However, a set of restrictions as to when the notes may be declared payable is present in the majority of cases. These restrictions are often dependant on a basket amount; the debt declared payable may not be inferior to that amount. If the basket amount is ten million, cross-default or cross-acceleration is not possible if the other debt declared due and payable amounts to nine million. Consequently, it goes without saying that the size of the basket is of interest for the subject of investor protection, since the cross-acceleration or cross-default covenants lose their edge should the basket amount be too excessive.

[93] Terms and Conditions for Ferronordic Machines AB's maximum SEK 400,000,000 12.00 % Bonds, ISIN SE0004020766.

The usage of the mechanisms behind the covenants varied very little amongst the bonds of the survey. Therefore, I chose only to investigate differences is basket values since I believe this is vital for the usability of the clause. All bonds, except for three, made use of a covenant regarding cross events of default- or acceleration. The basket amounts varied from SEK one million, to SEK 150 000 000. In some instances, the basket amount was not applicable if owed to a group company—which drastically decreases the clause's value. The average basket amount according to the data of the survey was just above SEK 31 000 000 (31 021 470,59). The average number is however not particularly interesting since the volume circulating of the different indentures varies greatly. More interestingly is the proportion of basket size to the aggregate value of the notes (*i.e.* volume circulating), which in average amounted to 6.13 per cent. In light of this number, it may be possible to affirm standards in the SSDA's standard agreement that span within a range not too far from it. The empirical study showed rather deviating numbers of basket sizes. Some were very large in proportion to the bond's volume, which is detrimental to investors and beneficial for borrowers.

3.3.7 Ratios, statements and certificates

The covenants clauses listed below provide creditors with the ability to get a precise and distinct image of the issuer's financial health. As the covenants' purpose and application is rather forthright, limited questions arise as to problems with legal implications in practice. Hence, limited space will be appointed to them here.

3.3.7.1 LTV

Loan to value-covenants provide creditors with a distinct and precise image of the issuer's financial health.

"So long as the Bonds remain outstanding, the Company undertakes to ensure that the ratio of Total Net Senior Debt to Total Loan Book is not greater than [...][(...)] per cent."[94]

Only seven out of thirty-eight bond terms contained a loan to value-covenant. The most viable explanation to this is most likely that a loan to value-covenant is fundamentally interesting for corporations akin to one another, typically within the same line of business. As the empirical study shows, such is the case. All issuers that employed this covenant were either in the real estate- or (consumer) finance sector. These sectors are typically highly leveraged. The LTV-covenants of the indentures typically required a loan to value ratio of 80-85 per cent. Two real estate companies required a loan to value ratio of 60-75 per cent., with varying leverage allowed

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[94] Terms and Conditions for Bayport Management Limited Maximum SEK 700,000,000 Bonds, ISIN SE0003617216.

depending on the type of property mortgaged. For example, properties with attractive locations were permitted to have higher leveraging.

3.3.7.2 Interest coverage ratio

"So long as any Bonds remain outstanding, the Company undertakes to ensure that the ratio of Funds From Operations to Interest Expense is not less than […][(…)] per cent."[95]

Interest coverage ratio-based covenants were employed in fifteen indentures, making it one of the most frequently occurring financial ratio incurrence covenants.

Interest coverage ratios are very efficient in revealing the present financial health of the issuer, since the ratio displays the issuer's abilities to pay interest costs necessary for servicing its loans. The higher the ratio, the better is the issuer's abilities to stay afloat during harsher times in case of downturns in revenue. The more risk and volatility involved in the issuer's business, the higher should the minimum interest coverage ratio be to protect the investor from suspension of payment.

Fourteen bonds in total were issued in 2013. Of these, eight bonds included an interest coverage ratio. It may therefore be asserted that interest coverage ratios are more frequently used today, since the remaining seven bonds employing an interest coverage ratio had issue dates ranging from late 2010 until late 2012. In other words, it is a trend on an uprising. Personally, I think that it is a very usable covenant. It should work in every company and therefore it may be suggested that it would be a good idea to open up for the usage of it in the SSDA's standard agreement.

3.3.7.3 Minimum equity and minimum cash

These covenants are different from the ones that are ratio-based, since they are maintenance-oriented rather than incurrence-oriented.

"*So long as any bonds remain outstanding, or at or until such other date as set forth below, the Company undertakes to ensure that*

- *(i) the Equity amounts to not less than SEK […] (where "Equity" means the consolidated book-value of the Group's total shareholder's equity according to the latest Financial Report.) and*
- *(ii) that there at all times is an Available Cash Amount (which means that the Company has cash or cash equivalents (Sw. kassa) corresponding to at least 7 per cent. of the outstanding Nominal Amount available at its disposal.*"[96]

[95] Terms and Conditions for Bayport Management Limited Maximum SEK 700,000,000 Bonds, ISIN SE0003617216.

[96] Terms and Conditions for Catella AB's (publ) Maximum SEK 300,000,000 Senior Unsecured Bonds, ISIN SE0004809630.

Ten bonds utilized a minimum equity-covenant. Amounts varied greatly. The purpose of having an equity covenant is to ensure company creditors that the issuer is financially fit. The purpose behind a minimum cash-covenant is to ensure financial fitness in a narrower scope; presumably, that sufficient cash is available to service outstanding debt. The covenant was employed in seven cases.

3.3.7.4 Debt to EBITDA ratio

"*The Company undertakes to ensure that, the Net Debt to EBITDA ratio does not on any Reference Date exceed [...] during the period from and including [...] until the Redemption Date.*"[97]

The debt to EBITDA ratio displays, in sum, the issuer's abilities to decrease its outstanding debt liabilities. As a result, the assertion that this should be a popular covenant to employ seems fitting. Even so, the covenant was employed in no more than twelve cases. The required test to be met should this covenant not be breach stipulated a Net Debt to EBITDA ratio of between 2.5:1 and 6.0:1, with an average of 3.75:1. In some instances, it was stipulated that actions such as acquiring additional indebtedness of making disposals was subject to the Net Debt to EBITDA test being met.

3.3.7.5 Equity ratio

Equity ratio-covenants were used in only ten loan agreements. Sometimes, the covenant was used as a complement to minimum equity amounts (as a maintenance covenant), and sometimes it was used solitary. Divergences between theoretical purpose, *i.e.* defining the issuer's equity compared to its total assets, and practical implication, was scarce. Investors should however ensure that the definition of the ratio's variables is in accordance with market practice, neither being too wide nor too narrow. The requirement spanned between 15 per cent. of equity compared to total assets, and 40 per cent. of equity compared to total assets. The average ratio required was a little over 25 per cent. In one instance it was stipulated that this test ought to be met in order for the borrower to be allowed to perform value transfers to shareholders, which seems to me like an admirable approach.

"*The Agent is, on behalf of the Bondholders, entitled to declare all, but not only some, of the Bonds due for payment immediately, or at such time as the Agent determines by notice to the Company, if at any time; the Equity to Total Assets Ratio fall below 25 per cent.*"[98]

3.3.7.6 Capital coverage ratio

The capital coverage ratio-covenant was only used in two cases. This comes as no surprise since the covenant has a clear field of application, which only fills its intended purpose when comparing an outstanding loan book is compared with a senior loan to ensure that the leverage is not too high.

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[97] Terms and Conditions for Ferronordic Machines AB's maximum SEK 400,000,000 12.00 % Bonds, ISIN SE0004020766.

[98] Terms and Conditions for Arise Windpower AB's (publ) SEK 350,000,000 Bond, ISIN SE0004518769.

"*For as long as the Bonds remain outstanding, the Company undertakes to procure that the Group maintains a Total Shareholders' Equity to Capital Employed ratio of at least […] per cent. (where Capital Employed means the Total Shareholders' Equity plus Interest Bearing Debt)*." [99]

3.3.7.7 Listing requirements

The reason to employ a requirement for listing is a necessity in order to entice investors that are not allowed to invest in securities that are not traded publicly.[100]

"The Issuer shall use its best efforts to ensure that the Notes are listed on NASDAQ OMX Stockholm within two (2) months after the First Issue Date, and that they remain admitted for as long as any Notes remain outstanding or, if such listing is not possible to obtain or maintain, listing on another Regulated Market. Upon any issue of Subsequent Note, the Issuer shall promptly, but not later than ten (10) Business Days after the relevant issue date, procure that the volume of Notes listed is increased accordingly."[101]

All bonds of the study except for one had listing requirements, to some extent, included in the terms and conditions. The majority part had strict requirements for listing, whereas a not negligible amount of bonds had requirements on a best- or reasonable effort basis. The absolute majority of the bonds defined the regulated marketplace where the bonds should be admitted. NASDAQ OMX Stockholm was the default choice in most cases—and in several instances—a listing on the Corporate Bond list on NASDAQ was preordained.

3.3.7.8 Financial statements

The incorporating of clauses demanding the issuer to make available its financial statements is imperative for any loan agreement, those of high-yield bonds included. This statement is backed by the results of the empirical study, showing that all issuers where—according to the terms and conditions of their respective indenture—required to publish financial reports.

"*The Issuer will make the following information available to the Noteholders by way of press release and by publication on the website of the Group:*

(i) as soon as the same become available, but in any event within […] [(...)] months after the end of each financial year, its audited consolidated financial statements for that financial year;

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[99] Terms and Conditions for PA Resources AB's (publ) SEK 850,000,000 Bond, ISIN SE0003652577.

[100] Compare with *supra* at p. 32.

[101] Terms and Conditions for Cloetta AB's (publ) Senior Secured Callable Floating Rate Notes, ISIN SE0005364437.

(ii) *as soon as the same become available, but in any event within […] [(…)] months after the end of each quarter of its financial year, its unaudited consolidated financial statements or the year-end report (bokslutskommuniké) (as applicable) for such period.*"[102]

Few notable aspects arose as regards this covenant. The vast majority of issuers were required to publish reports on a quarterly basis; only three were allowed to publish the statements semi-annually. Three facilities agreements demanded publication of financial statements in accordance with the rules required by NASDAQ OMX, from time to time.

3.3.7.9 Compliance certificate

Few noteworthy features of the usage of compliance certificate-clauses were recognized. In general, it may be submitted that it is hard to ascertain the general purpose behind a compliance certificate, since the definition of what the certificate is supposed to show compliance to fluctuate. Nevertheless, all of the bonds of the survey employed a compliance certificate, that is, a certificate requiring *at least* that the issuers guarantees compliance to the terms and conditions of the loan agreement. In some cases, the form of compliance certificate stipulated stricter requirements, *inter alia* adherence to the fulfilment of certain financial ratios and incurrence tests.

"*If the Agent is investigating an event or circumstance which it reasonably believes is an Event of Default or which would (with the expiry of a grace period, the giving of notice, the making of any determination or any combination of any of the foregoing) constitute an Event of Default, the Issuer shall within 30 days from the Agent's request submit a compliance certificate to the Agent. Such compliance certificate shall be in a form agreed between the Issuer and the Agent and shall contain (i) a confirmation that no Event of Default has occurred (or if an Event of Default has occurred, what steps have been taken to remedy it), (ii) a confirmation that the Liquid Assets are equal to or exceeds the Debt Service Amount, and (iii) copies of any notices sent to the Regulated Market on which the Notes are listed.*"[103]

The demand to provide compliance certificates was hence strict across the board. In relation to these certificates, a few aspects stand out as being of interest. Principally, issuers were required to publish compliance certificates in conjunction with the publication of financial statements, meaning quarterly as a default. In some instances though, issuers were subject to stricter requirements. These requirements were found in three cases and stipulated that the issuer should provide a compliance certificate upon incurring new financial indebtedness, making a distribution or making a restricted payment. In one instance, it was stipulated that a compliance

[102] Terms and Conditions for SAS AB's (publ) Senior Unsecured Fixed Rate SEK Notes, ISIN SE0005423597.

[103] Terms and Conditions for SAS AB's (publ) Senior Unsecured Fixed Rate SEK Notes, ISIN SE0005423597.

certificate, provided quarterly, should certify compliance with the incurrence test.

3.4 Closing remarks

I conclude that divergences between covenants' purpose and practical implication are not greatly deviating when it comes to how the outline of the covenants of the study has been drafted. This statement is supported by the comparison between the purposes identified in relevant literature, and how covenants are actually drafted in high-yield bond loan agreements. That statement does not however mean that there is a seamless transition in how covenants should be applied in practice (if their meaning is interpreted like anticipated), compared with the envisaged and intended purpose of why the same type of covenants are imposed on the borrower from the outset. More than a few deviating aspects were in fact identified in the course of the comparative test—not only due to the diligent use of game-changing carve-outs and erratic phrasings—but also discrepancies that are not only just perceptible, but instead affects the function of the clause taken as a whole. This presses for a more in-depth analysis, especially as regards the latter.

In sum, it may be affirmed that most covenants' legal implication corresponds to the envisaged purposes behind employing them, should carve-outs be non-existent. A situation where this takes place is however highly unlikely, since almost no covenants were given a "default" wording without exceptions. This statement should nonetheless not be understood as being undesirable: quite the opposite. Creditors and debtors ought to be given space for negotiation and it may be submitted that most covenant clauses' content have been subject to scrutiny and negotiation from both parties to the loan agreement. This asserts that the contents of the contract should match the will of the parties.[104] On account of this, the analytic part will focus on the divergences that may be unwanted, rather than as a result of skilful negotiation; meaning discrepancies shown to occur due to indistinguishable or ambiguous definitions—such as the use of the term material adverse effect, or problems with importing covenants from foreign jurisdictions and applying them to an agreement that is subject to Swedish law, as is the case with the negative pledge-covenant.

[104] The substantial usage of carve-outs could perhaps be explained in light of the discrepancy of term sheet contents, compared to executed terms and conditions. That is however a question that is not covered by the scope of this paper.

4 Conclusions from the comparative test

4.1 Introduction

The comparative test between covenants' purpose in theory and their practical implication in reality displayed many divergences. It is however quite necessary to separate the divergences that are a cause of negotiations between the lender and borrower, and divergences that appear to be *inherent* in certain covenant usages. For expected reasons, these divergences found in negative pledge-covenants and material adverse effect-terminologies will henceforth be the focus of the coming chapter.

4.2 Negative pledge-covenants

As we have learnt, a negative pledge-covenant—together with the pari passu-clause—have a central meaning in most loan agreements. This is admitted by the clause's way of restricting the issuer's ability to grant security in company assets to in order to incur additional indebtedness.

A negative pledge-covenant can be used as a substitute for, as well as a complement to, traditional securities. By including this covenant in a loan agreement, the noteholders essentially ensure that the assets of the issuer will be distributed equally amongst the unsecured creditors upon the debtor's insolvency. The value of the typical negative pledge covenant for the investor is however subject to doubt, due to one question that arises: can a third party that has accepted pledged security, in conflict with a negative pledge-clause, realize the security upon the debtor's default?[105] In ascertaining the practical legal value of a negative pledge-covenant for an investor, the subject ought to be of fundamental significance.

To clarify the complexity of this problem, I will exemplify the situation in an illustrative manor; an issuer of a high-yield bond the and its noteholders are entered into an agreement containing a set of terms and conditions ("Loan agreement A"), including a negative pledge-covenant that, *inter alia*, prohibits the issuer from creating any security over any of its assets, present or future. Despite this, the issuer raises additional indebtedness from Bank A and secures this indebtedness in company assets as set out in another loan agreement ("Loan agreement B") (let us also presume that the issuer was not hindered by a clause preventing it to raise additional financial indebtedness, for the sake of clarity). When the noteholders find out that the issuer has breached the terms and conditions of Loan agreement A, they accelerate the

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[105] Compare with Gorton, Lars and Sjöman, Erik, *Negativa förpliktelser och tredje män – särskilt om överträdelse av negative pledges i finansiella avtal,* Juridisk Tidsskrift, third edition, 2002, p. 506 et seq. [cit. Gorton et al.].

notes. This is because breaches of the terms and conditions, for example the negative pledge-covenant, cause an event of default of the notes under the loan agreement.[106] The acceleration of the notes means that the agent—on behalf of the noteholders—declares the notes payable. From the issuer's perspective this is not a very good thing; the principal derived from the bond issuing is most likely tied up in the business of the debtor and, as a consequence, assets need to be liquidated to repay the bondholders. If the issuer becomes insolvent as a result of this process, Bank A will have priority in the bankruptcy proceedings since Bank A holds security in the issuer's assets in accordance with Loan Agreement B. The asset pool was supposed to be reserved for the noteholders as well as other unsecured creditors, in accord with why the negative pledge-covenant was employed in the first place. Since Loan Agreement B breaches Loan Agreement A, the noteholders want to know if Bank A have the possibility to realize the claim, even though they have aided in breaching Agreement A by accepting assets as security—that were not allowed to be pledged as security—per Loan Agreement B.

Gorton and Sjöman has investigated this problem in their paper "*Negativa förpliktelser och tredje män – särskilt om överträdelse av negative pledges i finansiella avtal*", (*Eng: Negative pledges and third parties – especially concerning breaches of negative pledges in financial agreements*). The background to the whole predicament originates in the distinction between property rights *(Sw. sakrätter)*, and rights of obligation *(Sw. obligationsrätter)* under Swedish law.

An agreement may impose positive as well as negative obligations on its contracting parties. Negative pledge-clauses impose a negative obligation by hindering the debtor from making certain undertakings, related to providing security over its assets to secure loans. Other examples of negative obligations are seen in situations dependant on loyalty and trust, such as non-disclosure agreements or non-competition clauses, or certain undertakings in loan agreements related to the disposal of company assets, in ways that are detrimental to the creditors.[107] Examples of property rights are rights of ownership and rights of security, whereas rights of obligations typically signify the accomplishment of an obligation—positive or negative—such as paying an agreed amount on an agreed date.[108] Proprietary rights bind third parties, thus empowering separation rights and priority rights in bankruptcy. A right of obligation is a right that traditionally does not entail proprietary rights, and therefore, it only applies between the parties to the agreement, excluding any legal implications towards third parties.[109] This is because of a standard rule of contract under Swedish law, limiting the scope of parties subject to it to the contracting parties *(Sw: avtalets subjektiva begränsning)*.[110] This principle entails that it is

[106] See *supra* section 3.2.1.
[107] Gorton et al., p. 506.
[108] Gorton et al., p. 506.
[109] Gorton et al., p. 504, also compare with Håstad, p. 430.
[110] Gorton et al., p. 507.

impossible to obligate (*Sw. förpliktiga*) another party besides the contracting party, whereas no restriction is imposed as regards the ability to entitle (*Sw. berättiga*) third parties.[111] The principle of *numerus clausus,* meaning that it is not possible to create proprietary rights by means of contract, further limits the scope. The principle entails that if a party to an agreement is vested with a right that is neither by law, nor case law, acknowledged as a proprietary right—an agreement aimed at *contractually* manifesting a right with the same objective cannot be legally binding.[112]

As we have learnt, the negative pledge clause (if there are no carve-outs to it, which there usually is) perpetrates the practical implication that the debtor's assets is inflicted with a prohibition to be pledged as security for the raising of additional indebtedness. As such, it may be submitted that a negative pledge-covenant—given the principle of *numerus clausus*—under no circumstances should be able offer proprietary rights aiming to protect the issuer from the creditors of the issuer, compared to the protection that traditional security arrangements acknowledged by law can.[113]

Aside from traditional proprietary rights under Swedish law, impediments may also be imposed on certain assets by means of contract. Exemplifying this is contractual provisions in purchase agreements aiming to establish that the purchased asset shall be used in accordance with certain undertakings; that it for example may not be disposed of, leased, or pledged as security. These contractual impediments are by default only applicable between the sphere of the contracting parties.[114] Swedish case law and doctrine does however indicate that *limited* proprietary rights may be asserted to certain individual property, even though scholars do not entirely agree on this.[115] This is however not of material interest, nor significance, for the legal value of negative pledge-covenants. This has to do with the fact that these clauses are drafted so that they prevent the issuer from creating any security over *any of its assets*, rather than over a *specific asset*.[116] Since a proprietary right needs to be tied to a specific, individually determined item in order to bind third party acquirers—according to the Swedish cornerstone of proprietary law, *specialitetsprincipen* as devised in NJA 1910 p. 216—negative pledge-

[111] Gorton et al., p. 507. Also compare with Adlercreutz, Axel, *Avtalsrätt 1,* 12th edition, 2002, p. 138 et seq. [cit. Adlercreutz].

[112] Gorton et al., p. 507. Also compare with Håstad, p. 130.

[113] Gorton et al., p. 508. Also compare with Hessler, Henrik, *Allmän sakrätt,* 1973, p. 418. [cit. Hessler].

[114] Gorton et al. p. 508. Also compare with Hessler, p. 446.

[115] The question revolves around the ability to protect the property against a third party acquirer that has actual knowledge about an encumbrance that is tied to the property, and that is made in an agreement between the two contracting parties. Of particular interest is the cases NJA 1924 p. 329, NJA 1925 p. 80 and NJA 1940 p. 297. These cases ascertained that undertakings to pledge assets for security, which are strictly non-proprietary, have proprietary effect against third parties with actual knowledge of the undertakings. In light of how differently these cases have been interpreted by Swedish scholars Rodhe, Nial, Hessler and Håstad, it can hardly be appointed much legal value, according to Gorton. See Gorton et al., p. 508 et seq.

[116] In no instance did a negative pledge-covenant stipulate that no security was allowed to be created over assets that were specified, according to the study.

covenants appear to lack effect against third parties accepting security in breach of an initial negative pledge-commitment.[117]

In conclusion, I almost entirely agree with Gorton et al. The paper is prominently written and very accurate in its content. Whilst the authors are completely correct in theory as regards the observations of the value of negative pledge-clauses, I think that they underestimate the implication in loan agreements by comparing negative pledge-covenants to letters of comfort and *quasi-securities*.[118] It is however true, as Gordon et al. states, that the idea behind negative pledges is generally accomplished in all aspects—short of strictly legal. Albeit, is it possible to view the problem from an additional, more pragmatic angle?

I claim that the effects of negative pledge-covenants in practice largely correspond with the reason why they are employed. That does however require taking a different approach to how the covenant is used, by weighing in how the covenant aids in imposing leverage against the borrower to ensure adherence to the terms and conditions of the indenture by threatening to accelerate the notes upon breach of the clause. The recurrent usage of negative pledge-covenants amongst high-yield bond terms, legal advice being provided by some of the most skilled banking- and finance lawyers in Sweden, and the general manor in which the clauses are employed, should support this theory. This power of negative pledges is however, as it seems, not relying on the force of law. Rather, on the lender's belief that no debtor *wants* to breach the contract since this results in an event of default and acceleration of the notes. This ought to cause negative effects on the borrower than in no sense can be outweighed by the positive effects of being able to raise new debt from a third party by creating security upon its assets. Hence, negative pledges should in my opinion be seen as a very strong deterrent, not a *quasi-security.*

4.3 Material Adverse Effect

The presence of the seemingly vague term *material adverse effect* in loan agreements is in many ways questionable, especially considering how the term is (mainly) put to use: either, as an outer limit for the issuer's disposal rights of company assets, or as a limiter in no-merger clauses.

When considering the problem at hand, there are two ways in which to approach it. The first, and most difficult, is to try and establish how a Swedish court or arbitrator would interpret the term. Needless to say, this is no easy task and to reach satisfactory results one needs to look across jurisdictions and adopt analogies. Regardless of how well this

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[117] Håstad, p. 152, compare with Gorton, p. 510. The opinion is also shared with Hessler and Karlgren, see Gorton et al. p. 510. Also, there may be indemnification abilities and possibilities for reclaims in bankruptcy (even though these possibilities are seemingly not supported by Swedish law), but I will not approach these subjects since I believe that they stretch a bit too far from the initial purpose of the negative pledge-covenant.
[118] Gorton et al. p. 521.

argumentation is carried out, it would be impossible to attach a definition to the term since it will probably always need to be seen in light of each specific case. The second way is to proclaim that the difficulties arising as regards how to interpret the term *in the first place* means that it does not serve its purpose very well. I will try and argue for why investors should try to limit usages of the term in loan agreements, or to require that it is clarified in its contents so that it is easier to apply. This argument of mine is held regardless of the term's—very likely, (given the magnitude of its usage)—normative purpose that is exhibited by its wording. In other words, the ability for the concerned parties to chisel out what constitutes an MAE is probably not intended. This, in my opinion, causes a problem due to the origination of the term in two specific covenants.

Firstly, in the context of:

"Mergers and Demergers

a) A decision is made that any Material Group Company shall be demerged or merged into a company which is not a Group Company if such demerger or merger can be expected to have an Material Adverse Effect, unless the Agent has given its consent (not to be unreasonably withheld or delayed) in writing prior to the merger and/or demerger (where consent is not to be understood as a waiver of the rights that applicable law at the time assigns the concerned creditors).

b) The Issuer merges with any other person, or is subject to a demerger, with the effect that the Issuer is not the surviving entity."[119]

And where

"Material Adverse Effect means a material adverse effect on

a) the business, financial condition or operations of the Group taken as a whole;
b) the Issuer's ability to perform and comply with the undertakings set out in Clause 14 (General Undertakings); or
c) the validity or enforceability of the Finance Documents (including the ranking of the Transaction Security as set out in such Finance Documents)."[120]

And secondly concerning:

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[119] Terms and Conditions for Cloetta AB's (publ) Senior Secured Callable Floating Rate Notes, ISIN SE0005364437.
[120] Terms and Conditions for Cloetta AB's (publ) Senior Secured Callable Floating Rate Notes, ISIN SE0005364437.

“Disposal of Assets

The Issuer shall not, and shall procure that no Material Group Company, make(s) a Restricted Disposal, unless such disposal is carried out at fair market value and on terms and conditions customary for such transaction and provided that it does not have a Material Adverse Effect [...]”[121]

and where

"Material Adverse Effect means a material adverse effect on

a) the business, financial condition or operations of the Group taken as a whole;
b) the Issuer's ability to perform and comply with the undertakings set out in Clause […] (General Undertakings); or
c) the validity or enforceability of the Finance Documents.”[122]

My arguments start with the difficulties related to the application of no-merger clauses; identified despite of the non-prescriptive and normative outset of the MAE-term’s intended application. In this perspective, it may be affirmed that any investor would need formidable knowledge about the issuer’s corporation in order to fully assess whether a merger or demerger has resulted in a material adverse effect. Despite of the normative outset of the terminology and the inherent purpose in this, the term may in fact prove to be *too* vague and imprecise. It is even possible that investors would be required to hire external expertise to analyse whether a merger or demerger would have material adverse effect. A court or arbitrator would find it equally, if not even more, difficult. Hence, I dispute the value of clauses that employ material adverse effect-terms in the context of no-merger clauses by arguing that they confer a weak defence against unwanted actions due to the difficulties and costs associated with employing it. In large, the same applies to the value of no disposal-clauses since the investor would too be required to have an insight into the borrower’s business to fully ascertain whether a disposal has caused a material adverse effect or not. The circumstance of the sizeable group of investors apparent in high-yield bond indentures exacerbate the value of the covenants employing MAEs even more, by demanding greatly upon the agent to act reasonably in their interest in stating that a MAE has occurred.

In light of these particulars, I think that investors should refrain from relying to severely on covenants that are trusting in MAEs’ fulfilling their purpose. That statement does however seem to be conversing to the belief of legal advisers and investors given the magnitude of the usage of the term across the scope of the study, and the apparent unwillingness to employ another

[121] Terms and conditions for ÅR Packaging Group AB’s (publ) maximum EUR 115 000 000 bonds, ISIN SE0005224029.
[122] Terms and conditions for ÅR Packaging Group AB’s (publ) maximum EUR 115 000 000 bonds, ISIN SE0005224029.

mechanism that serves the same purpose.[123] Provided the validity of this observation and the probable result that the material adverse effect-terminology is chosen for its flexibility, a few aspects as regards the clauses' drafting may then be argued to be of importance for the sake of investor protection. This question revolves around the definition of the MAE in the terms and conditions; predominantly the scope of what the effect is deemed to be *on* (the example clauses above *inter alia* covers effects on the borrower's business, financial condition, operations and ability to perform its general undertakings in the loan agreement)—rather than simply employing a narrow definition that perhaps some borrowers may desire, in light of the lender's role as a creditor and not as a shareholder, thus meaning unconcern with anything but the debtor's ability to service the loan throughout its term and repay the principal. As such, borrowers may claim that definitions of MAEs including measurement on the financial condition or operations of the group should not be necessary. A wide definition of an MAE is nonetheless something that is beneficial and important for lenders to employ, since it covers a wider scope of negative scenarios possibly resulting in risks of the borrower ending up in financial distress.[124] Hence, I state that—absent the ability to remove MAEs entirely—a wide-as-possible scope like in the example clauses above should be insisted upon by investors.

A second way to approach the problem of MAEs was suggested; to try and define what a material adverse effect means. It is however unlikely that this is intended, instead it would be likely that legal advisors would have made the term easier to define in the first place. To solve this predicament in theory however, guidance can be sought in the case *Grupo Hotelero Urvasco SA v. Carey Value Added SL [2013] EWHC 1039 (Comm) (26 April 2013)* where the English High Court contemplated how to interpret a Material Adverse Change ("MAC") clause. This case illustrates quite well how certain aspects of the requisites of "material" and "adverse" should be interpreted even though it concerns a change rather than an effect.

[123] Consider perhaps that the incidence of MAEs should be viewed in light of borrowers' will to incorporate a term that is hard to define, and hence purposefully leads to difficult applications—meaning that the issue boils down to a question of leverage when negotiating loan agreements. This needs to be seen in the context of how vagueness can be beneficial to one party, and detrimental to the other, and the probable outcome of an interpretation that is most likely conservative rather than abrasive: in my opinion it should be harder to prove that a material adverse effect has not taken place, compared to that it *has*.

[124] Compare with Hiller, William H., and Finnegan, Cornelius T., III, *Simplify Your Loan Agreement to Earn Your Borrower's Goodwill,* Commerical Lending Review 14, 1998-1999.

4.4 Concluding remarks

Now the comparative test is concluded, both as regards negative pledge-covenants, material adverse effect-terms, and the remaining covenants from section 3.3.

The results and conclusions drawn will now be concluded in the analysis, with the ultimate purpose to answer the questions set out in section 1.2.

5 Conclusion

5.1 Introduction

This fifth and final chapter will conclude the paper. It will start with summarizing the risks that were identified throughout the course of this work, then discuss how these risks can be mitigated, and ultimately answer the theses.

This chapter will also include a short discussion of the possibilities of incorporating covenant practices within the SSDA's standard agreement.

5.2 Which risks have been identified?

Several risks of different source and proportion have been identified in the covenant practices within loan agreements of the Swedish high-yield bond sector. The ones most obvious and easily fixable are risks associated with limiting certain covenants' effects by creating a rigid network of carve-outs, thereby limiting the apparent effect that a covenant is anticipated to have in its default form. This incidence of frequent usages of carve-outs and borrower-friendly covenants is quite noteworthy, predominantly due to the fact that the bonds investigated are in fact high-yield, and often unsecured. This means that the bonds have low ranking in the debtor's balance sheet, compared to its senior financing. This riskiness should entail that creditors ask a lot of the debtor in terms of contractual safeguards—contradictory to what was just accounted for. The only answer to this question ought to be that investors chase yield in risker instruments, given the current macro economical market situation with low remuneration levels tied to safer investments. It may therefore be proposed that high-yield bond notes generally may be seen as rather attractive investments, in spite of the high levels of risk associated with holding them. This fact is of course not true across the board, but should bear some resemblance in practice. One should however not quickly disregard the riskiness of high-yield bond notes—a statement that I believe Swedish inventors would agree on. This is evidenced by the rather rigid network of covenants employed (even though carve-outs and exceptions may result in a less stringent level of protection than anticipated). This discussion aims to proclaim that it is safe to say—at least in relation to most covenants—that their contents have been negotiated. Unless the negotiated wordings' implication in practice is very deviating from the purpose behind employing the covenant, these practices are not very interesting to analyse since their implication should have been taken into account by the investor.

Regardless of the above, a few aspects of concern stand out and will nonetheless be accounted for. These risks were found in clauses permitting new financial indebtedness under basket sizes that were too great, cross-

default- and cross-acceleration baskets disproportionate to the aggregate value of the notes, as well as negative pledge-covenants with too many carve-outs; especially concerning the ability to create securities towards named creditors.

Of abundant interest is also the matter of risks having been identified in negative pledge-clauses, as well as regards covenants that rely on material adverse effect-terminologies. These risks are suggested to be of a different magnitude since it is probable that the investor did not anticipate them. The analysis of these two features did prove that they are in fact risks, even though it was argued that the general leverage created by covenants is also true as regards negative pledges, meaning that desired effect is still reached in practice—regardless of the limitation in the covenant's applicability towards third parties. The same does, in my opinion, not apply to clauses relying heavily on material adverse effect-terms as an outer limit for their applicability. This conclusion was held in part by establishing that, despite of the non-prescriptive character of the term, its application may not be suitable within the context of no-merger clauses and no-disposal clauses due to the levels of insight into the issuing companies that is required.

5.3 How can the risks be mitigated?

Risks associated with carve-outs on a general level are easily avoidable, but would in practice require negotiation skills and leverage against the borrower. Provided that high-yield bonds are in fact considered to be attractive investments in Sweden, issuers that find presumptive investors too tough at the negotiating table could simply choose not to bestow upon them any notes. This means that great deals of leverage should be required in order for investors to be able to negotiate terms drastically more favourable for them (in practice, the indenture ought to be undersubscribed). In this ideal scenario where investors can afford to make demands however, they should strive towards omitting having too generous carve-outs in key covenants. This especially applies to permitted new financial indebtedness, which evidently may result in the debtor's cash flows needing to compete when it comes to servicing the noteholders' outstanding loan. Of material risk is the scenario where a debtor is permitted to incur additional financial indebtedness in certain specified scenarios or from certain named entities (especially if it means the accumulation of additional senior ranking debt), in combination with a basket that is too great. A few notable aspects also arose when analysing the cross-default- and cross-acceleration basket values. In that context, and of distinct concern, were basket values that were far too immense in relation to the notes' aggregate value. This aspect quickly renders the covenant quite useless—hence making it a typical and central deviating factor amongst practical covenant wordings compared to a hypothetical purpose. As a consequence, investors should ensure that these basket values are kept at a minimum. Furthermore, a mechanism where covenants aiming to restrict disposals and distributions are dependant on the meeting of ratio tests of varying nature—such as the equity ratio—should be encouraged to prevent value stripping measures, as oppose to usages of

vague terms such as material adverse effect. The latter are instead argued to be hard to put into context—meaning that covenants whose mechanisms are built on the term are rather blunt instruments. Due to the unlikeliness of market players stepping away from MAE-usages though, investors should strive towards widening the term's scope to the extent it is possible, to also include effects on the issuer's business, financial conditions and operations. This wording is claimed to be advantageous, especially in light of the often unsecured and risky nature of high-yield bonds.

Lastly, investors should at least to some extent be concerned about the proposed lack of applicability of negative pledges-covenants—*i.e.* their lack of effect outside of the contractual relation between lender and borrower in a strict legal sense—even though it was argued that the lenders' leverage and enforcement rights provided by the loan agreement ought to create remarkably greater protection than a *quasi-security* would.

5.4 Concluding remarks

This paper set out to answer the question of how covenants are used in Swedish high-yield bonds, a matter that had previously not been looked into from a comparative and investigative perspective. The paper has answered this question by presenting to the reader which covenants are most frequently occurring on the Swedish market, as well as their given wording. When knowing the wording and content of each covenant, it is possible to ascertain their value for the investor by analysing the effects of carve-outs and exceptions to their default form. Several aspects carrying risk have been identified throughout the course of this analysis; some directly by looking at the wording of the covenant, hence easily comprehended and mitigated, and some of more concealed nature. These latter risks became of focus since they were deemed to entail the most serious and unanticipated risks for investors looking to safeguard their capital.

As the question arises whether the comparative test displays that the purpose of covenants in Swedish high-yield loan agreements is satisfied, the answer ought to be that it does so—for the most part. Aside from a few possible legal pitfalls associated with the usage of negative pledge-covenants and the inherent vagueness in material adverse effect-linked terms, my general conclusion is that covenant packages seem to work purposefully in practice. Any investor does however need to ensure that carve-outs, baskets and other exceptions to clauses' applicability does not inflict too greatly on their protective value.

Covenant usages on the Swedish market for high-yield bonds are shown to be rather uniform when analysing them from a wider perspective. If one however drills down into each clause's wording, material divergences appear even though the common characteristics are shared. I conclude that this is something that the market needs, and hence that it is neither possible nor desired to strive towards standardizing templates for covenants across the board. There is truly an inherent problem in creating standardized

templates for covenants, which is evidenced by the lack of them in the SSDA's standard agreement. To create uniformity within all areas of covenants would be difficult, but it would perhaps be possible to standardize templates regarding certain aspects such as basket values in proportion to volume circulating of the notes. It does however need to be understood that flexibility ought to be key, since covenants should be tailored to the specific needs of the borrower, and specific risks tied to the borrower's business. Therefore, I find it very unlikely that a uniform covenant template will evolve any time soon. In the future it is possible that such templates will be used even though it is more likely, in my opinion, that several different covenant templates will be utilized depending on a number of parameters innate in the issuer's business and financial strength.

In conclusion it may be affirmed that the reader now should comprehend how covenants are used in loan agreements of Swedish high-yield bonds, by having taken part of the results of an empirical study that illustrates the wording of the most important covenants. This paper then comparatively analysed diverging aspects between the reasons behind employing these covenants and their anticipated implication in practice. Certain matters of importance as regards elements of risk where identified throughout this course of this comparison, leading to some criticizing arguments as to how some covenants have been drafted and some critique as to inherent complications in certain covenants. As regards the critique concerning the drafting of certain covenants, it is quite likely that content that has been subject to my scepticism throughout this paper has been a result of leverage in negotiation rather than poor drafting. The latter situation should be highly unlikely given the proficiency of the legal expertise employed to execute the loan agreements.

Supplement A

The bonds that have been part of the empirical survey:

Issuer	*ISIN Code*
Akelius Fastigheter AB (publ)	SE0004649739
Arise Windpower AB (publ)	SE0004518769
Bactiguard Holding AB	SE0004296671
Bayport Management Limited	SE0003617216
Bayport Management Limited 2	SE0004649713
Bergteamet Holding AB (publ)	SE0005364411
Björn Borg AB (publ)	SE0004545192
Catella AB	SE0004809630
Cloetta AB (publ)	SE0005364437
CLS Holding PLC	SE0003918093
Corem Property Group AB (publ)	SE0005162856
DDM Treasury Sweden AB (publ)	SE0005280831
Estea Sverigefastigheter 2 AB	SE0004867331
Etraveli AB (publ)	SE0005393220
Ferronordic Machines AB	SE0004020766
MCB Finance Group PLC	SE0005100567
MCB Treasury AB (publ)	SE0004489672
Millicom International Cellular S.A.	SE0004809663
Millicom International Cellular S.A.	SE0004809655
Nordax Finans AB (publ)	SE0005126406
Opus Group AB (publ)	SE0005466034
Orc Group Holding AB (publ)	SE0004872851
PA Resources AB (publ)	SE0003652577
PA Resources AB (publ)	SE0005392834
Real People Investment Holdings Ltd.	SE0005392560
Rederi AB Transatlantic (publ)	SE0005249299
RusForest AB	SE0003945385
Ruric AB	SE0003045848
SAS AB (publ)	SE0005423597
Scandinavian Air Ambulance Holding	SE0005249679
Sefyr Värme AB (publ)	SE0004452902
Swedish Orphan Biovitrum AB (publ)	SE0004649747
Svensk FastighetsFinansiering AB	SE0004389914
Svensk Hypotekspension Fond 1 AB	SE0003428457
Svensk Hypotekspension Fond 1 AB	SE0003428465
Trigon Agri A/S	SE0004019008
Wihlborgs Fastigheter AB (publ)	SE0005222924
ÅR Packaging Group AB (publ)	SE0005224029

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