



The Equity Cure Provision—Saving Debt with Equity

Bukola Mabadeje, Esq.

For many sponsor backed borrowers, and this would include technology companies which have raised at least one round of financing, the equity cure provides a lifeline which isn't necessarily available to traditional borrowers. The equity cure is a provision in loan documents which permits the borrower to receive into the company, equity capital in most cases, or subordinated intercompany debt in other instances and to apply the proceeds in such a way as to bolster certain financial metrics, with the result that the borrower is able to stave off a loan default. The provision gives the borrower one more alternative where it would otherwise have been forced to seek a loan modification, waiver, forbearance, or worse, acceleration of the debt.

The cash infusion from the issue of equity enables the borrower to boost its cash flow or EBITDA in order to meet financial covenants such as the operating cash flow ratio, debt service coverage ratio, or leverage ratio. These financial covenants which are a key component of cash flow loans provide the lender with periodic snapshots of the borrower's overall financial condition—a must where the lender looks to the borrower's available cash flow for debt servicing and eventual payoff of the debt. For the lender, in addition to injecting the company with much needed cash, the equity cure signals the sponsor company's commitment to the growth of the borrower. Nonetheless, the lender is also keen to ensure that the equity cure isn't misused by the borrower and the sponsor, and so strict conditions are imposed including:

(a) **Type of equity**—Some equity cure provisions go as far as prescribing the exact type of equity that may be issued by the borrower in obtaining equity proceeds. Most common is the use of common stock as the applicable equity security. Where the borrower is able to negotiate the use of preferred stock, the lender would usually dictate the characteristics of such stock including by providing that any negotiated features of such stock e.g. convertibility, preferential dividends, redemption, maturity etc. are not triggered until a given period after maturity of the loan. This is to ensure that the lender's payment priority is not accidentally tripped by equity which has the elements of debt.

(b) **Source of capital**—The equity proceeds may come through equity issued directly by the borrower, or may be the proceeds of a capital call carried out by the sponsor, which is then contributed to the borrower. In transactions where the

borrower is comprised of a group of related entities, the equity cure provision could limit the equity proceeds to funds provided from outside the loan party group in order to prevent an incidence of round tripping where there is technically no new injection of funds, but simply book entries which have no positive effect on the borrower's financial position.

(c) **Timing of injection**—The equity capital is required to be received by the company within a cutoff period, which usually matches up with any applicable cure period for the delivery of financial statements under the loan agreement. Such period ranges from 10 to 30 days, with the borrower of course bargaining for more, rather than less time. The lender's interest is to ensure that the funds are received timely enough to meet the covenant requirement. This however does not prevent the borrower from receiving and applying the equity proceeds prior to the applicable compliance test date.

(d) **Equity amount**—While some lenders limit the amount of equity proceeds to the amount required to cure the default, other lenders only provide that the proceeds should at a minimum, cover the aggregate amount necessary to cure such event of default for such period, in essence permitting the borrower to accept more cash than is actually required to cure the default. The lender would of course prefer to limit the size of the equity cure to the amount required to cure the default such that the borrower does not use the equity cure as a backdoor route to funding the company in such a way as to prevent the lender from applying its default remedies. On the other hand, the borrower would negotiate to freely determine how much equity capital to inject.

(e) **Prescribed limits**—In addition to capping the dollar amount of the equity cure, the lender could also limit the frequency of the use of equity cure to a prescribed number of times during the term of the loan, or prevent its use for successive test periods. Similar to the cap on the amount of the equity capital which may be received, this is also to forestall a situation where the borrower uses the equity cure as a prop for its nonperforming business.

(f) **Application of proceeds**—The cash received must actually be put to use by the company in a way that improves its financial condition and not solely a book entry that serves no purpose. For this reason, one of the most negotiated aspects of the equity cure provision is the application of the proceeds. The



borrower would usually prefer to apply the proceeds to cash flow and EBITDA, while the lender's preference is to reduce the amount of the loan by prepaying the loan with the equity proceeds. In any case, even where the proceeds are applied to EBITDA, such proceeds may wind up being applied to reduce the loan where the loan agreement contains excess cash flow provisions.



Bukola Mabadeje is an Associate in the Bank and Finance Practice Group in the San Francisco office. She can be reached at 415.227.3510 or bmabadeje@buchalter.com.