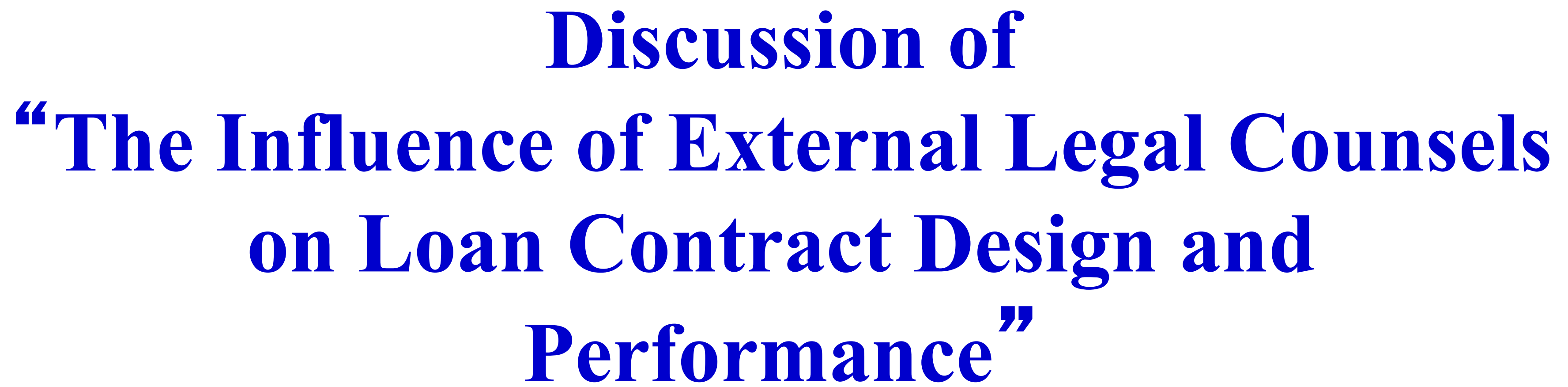


Discussion of “The Influence of External Legal Counsels on Loan Contract Design and Performance”

Daniel A. Cohen

Vanderbilt University

ABFER Conference

Singapore, 23 May 2023

Summary

- Motivated by the observation that there is no empirical evidence whether external legal counsel (ELCs) affect loan contract design of syndicated loans, authors examine:
  1. Do ELCs impact the loan contract design over and above market factors, borrower, and lender characteristics?
  2. If so, what is the mechanism of such an effect and what are the observed consequences?
  3. What soft information is provided by ELCs?

Main findings

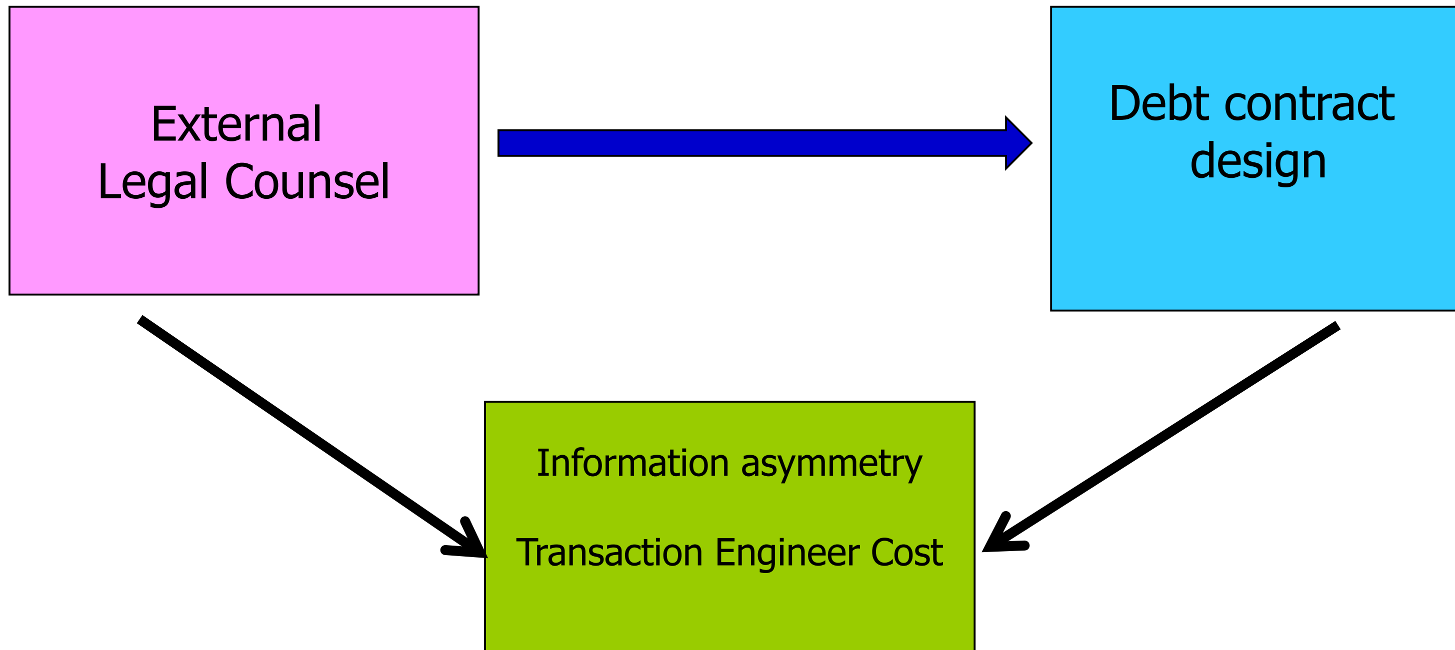
- ELCs plays a significant role in the design of debt contract terms
- Consistent with a transaction cost engineer hypothesis, the authors find that loans involving 'connected' ELCs are characterized by lower spreads and a more flexible covenant package which is interpreted as a smoother flow of soft information between the contracting parties
- Focusing on future loan performance, the findings suggest that loans with connected ELCs are less likely to be downgraded or experience default.

Big picture – is this worth looking at?

- Important study – adds to our understanding as to the design and performance of debt contracts in the syndicated loan market over and beyond lender and borrower characteristics
- Role of external legal counsel in financial markets and disclosure beyond client advocates and gatekeeper roles
- Research question seems to be well motivated as it is not clear *ex ante* whether and how ELCs affect loan contracts terms and performance
- Relevant to a large audience – accounting, finance and law disciplines

Conceptual Level

- Understand the relation between external legal counsel and debt contract design and subsequent performance over and above borrower characteristics and other factors identified in the literature to date.
- While there is an extensive theoretical underpinnings for the issues examined, the authors do not offer a 'real theory' and predict that



Relation to prior research

- Two streams of literature – loan contract design and the role of legal experts in financial markets
- DeFranco et al. (2020) – focusing on the bond market, bonds issued by firms advised by same legal counsel have similar covenant restrictiveness
  - Consistent with corporate law literature that debt market intermediaries contribute to the standardization and rigidity of debt contractual terms (Kahan and Klausner 1993, 1997; Choi and Triantis 2012)
- Effect of internal and external legal counsel on financial reporting and disclosures – positive effects on financial reporting quality
- The innovation in the current study is the unexplored role of ELCs – the transaction cost engineer channel beyond the advocacy & gatekeeper roles

Contract theory - mechanism

- Might want to consider an in-depth discussion of the underlying agency/contract theory and how it relates to the stated research objectives
- Debt covenants control agency problem by restricting managerial behavior (Jensen and Meckling, 1976; Smith and Warner, 1979)
- Aghion and Bolton (1992) - the design of financial contracts exploits two mechanisms:
  1. A contract can align the interests of the two parties *ex ante* in a way that there is little disagreement about the desired action *ex post*
  2. When interest alignment is challenging to achieve, the contract can reallocate decision rights *ex post*, in such a way that the party in control decides on the action taken. The optimal contract trades off *ex ante* interest alignment against *ex post* control transfer.

Contract theory

- Aghion and Bolton (1992) – contracts are **incomplete** since future states of nature are not contractible
  - Contractual incompleteness makes it impossible to specify different actions in future states and thus creates incentives for wealth expropriations
  - Contractual incompleteness can be mitigated by making *ex-post* control allocation contingent on covenants correlated with the state of nature
  - Optimal contract involves a monetary return for the manager and a control allocation rule
- Rajan and Winton (1995) – covenants offer banks incentives to monitor borrowers and such activities are welfare increasing

- The literature documents significant heterogeneity in the use of covenants across firms (Skinner, 2011; Christensen et al., 2016). - See the related discussion in Bushman et al. (2021).

More on incomplete contracts

- The incomplete contracting theory also emphasizes the role of contract **renegotiation** (Huberman and Kahn (1988, 1989), Aghion, Dewatripont, and Rey (1990, 1994) , Christensen et al., 2016)

- Huberman and Kahn (1988) argue that contractual terms can be designed in a way that becomes suboptimal *ex post* and triggers renegotiation to restore *ex post* efficiency

- Since the initial contract serves as the "disagreement point" in future renegotiations, the original contract affects the renegotiation outcomes and thus can influence *ex ante* incentives (Christensen et al., 2016).
  - this strategic renegotiation explains the presence of seemingly too restrictive clauses in debt contracts.

Contract theory – law scholarship perspective

- Corporate law literature on the design and variation of debt contracts (Choi and Triantis, 2012; Triantis, 2013)
  - Rigidity and standardization in contract design received significant attention in the legal literature
  - Boilerplate provisions are remarkably resistant to change, even in the face of shocks such as adverse judicial interpretations. Contracting parties are reluctant to take the risk of departing from provisions that have interpreted and enforced by the courts
  - Covenant and collateral terms evolve in response to changes in market conditions, such as expansion and contraction in credit supply.

Building on the adverse selection and moral hazard theories of covenants and collateral, Choi and Triantis (2012) demonstrate that an expansion (contraction) of credit will lead not only to a decrease (increase) in the interest rate but also a reduction (expansion) of covenants and collateral through lessening (worsening) adverse selection and moral hazard problems.

Contract theory important implication – covenant mix

Christensen and Nikolaev (2012):

"Building on contract theory, we argue that financial covenants control the conflicts of interest between lenders and borrowers via two different mechanisms. ***Capital covenants*** control agency problems by aligning debt holder–shareholder interests. ***Performance covenants*** serve as trip wires that limit agency problems via the transfer of control to lenders in states where the value of their claim is at risk. Companies trade off these mechanisms. ***Capital covenants*** impose costly restrictions on the capital structure, while ***performance covenants*** require contractible accounting information to be available. Consistent with these arguments, we find that the use of **performance covenants relative to capital covenants** is positively associated with (1) the financial constraints of the borrower, (2) the extent to which accounting information portrays credit risk, (3) the likelihood of contract renegotiation, and (4) the presence of contractual restrictions on managerial actions. "

Research design - Endogeneity

- The authors acknowledge non-random/selection issues – analysis in Table 7, using various fixed effects structures

- Related issue: potential endogeneity in the relation between covenant terms and debt pricing (e.g., Smith and Warner 1979; Bradley and Roberts 2004; Costello and Wittenberg-Moerman 2011)
  - Instrumental variable approach? Simultaneous estimation analysis – see DeFranco et al. (2020)

Suggestion – include covenant mix variable

- ***Performance covenants***, which tend to rely on income statement numbers, act as ***"trip wires"*** that facilitate the *ex post* contingent allocation of control rights to lenders outside of bankruptcy, when the borrower's performance deteriorates (Aghion and Bolton 1992; Dewatripont and Tirole 1994; Dichev and Skinner 2002; Christensen and Nikolaev 2012).
  - Performance covenants are timelier indicators of distress.

- ***Capital covenants***, which rely on balance sheet numbers and are not as sensitive to borrower performance, primarily align borrowers' incentives with those of creditors *ex ante*.

- How is this going to vary with ELCs attributes and mechanism you introduce in your paper? Implement and follow Christensen and Nikolaev (2012) approach
- You follow closely Bushman et al. (2021) empirical research design – they include covenant mix as one of the three main variables of interest

Suggestion - Performance Pricing

- Examine performance pricing grids, which specify the interest rate as a function of one of several different measures of borrower performance (Asquith, Beatty, and Weber 2005; Ball, Bushman, and Vasvari 2008).
  - Unlike debt covenants, which do not compensate lenders until they are violated, pricing grids automatically update the cost of financing
  - Similarly, debt covenants do not reduce the costs of unexpected improvements in borrowers' credit quality, which is not the case when pricing grids are used.

Suggestion - Performance Pricing

- Might consider three types of pricing grids (Ball, Bushman, and Vasvari 2008; Christensen and Nikolaev 2012):
  1. capital-based, which rely on accounting measures used by capital covenants;
  2. profitability-based, which rely on accounting measures used by performance covenants; and
  3. credit rating-based.

- How is it going to vary with Connected ELCs?

Research Design – minor issues

- Control for investment opportunities? Loan officer characteristics in light of Bushman et al. evidence. Underwriters' role?
- Renegotiations? Restructuring out of courts?
- Some anecdotal evidence examples to give a sense on the importance of ELCs
- Based on the discussion in legal studies, control for ‘lender friendly’ vs. ‘borrower friendly’ (i.e., covenant lite) – relates to imbalances in market demand and supply (the last credit cycle prior to 2007 financial crisis)
  - Who has market power? Bargaining?

In conclusion

- Overall, an interesting study
- The paper addresses a relevant and important issue to a large audience
  - learned a lot from it
- Expand conceptual underpinnings - contract theory addressing agency issues given the information problems of adverse selection and moral hazard. Tie together accounting, finance and legal work to guide empirical analysis
- Might want to consider some additional analysis consistent with related work on debt contracts/covenants

Thank you!