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Covenant Violations and Dynamic Loan Contracting

Felix Freudenberg†  Björn Imbierowicz‡  Anthony Saunders*  Sascha Steffen§

Abstract
This paper examines the dynamic allocation of control rights in private debt contracts of firms. We show that a covenant violation in the prior loan contract implies a stigma for borrowers which results in stricter loan contract terms in subsequent new loan contracts. Our analyses reject potentially other explanations such as firm characteristics or agency problems between the lender and firm management, shareholders or public debtholders. After covenant violations in the prior contract, new loans have on average 18bps higher spreads and include more of those covenant types which also have been violated in the prior contract, with tighter thresholds.

JEL Classification:  G21, G32, L14.
Keywords:  Control Rights, Covenant Violation, Dynamic Loan Contracting, Stigma.

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