

# Accepted Manuscript

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PII: S0929-1199(17)30317-6  
DOI: doi: [10.1016/j.jcorpfin.2017.05.009](https://doi.org/10.1016/j.jcorpfin.2017.05.009)  
Reference: CORFIN 1203  
To appear in: *Journal of Corporate Finance*  
Received date: 17 May 2017  
Revised date: ###REVISEDDATE###  
Accepted date: 19 May 2017

Please cite this article as: Felix Freudenberg, Björn Imbierowicz, Anthony Saunders, Sascha Steffen, Covenant violations and dynamic loan contracting, *Journal of Corporate Finance* (2017), doi: [10.1016/j.jcorpfin.2017.05.009](https://doi.org/10.1016/j.jcorpfin.2017.05.009)

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# Covenant Violations and Dynamic Loan Contracting

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## 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.

We thank Heitor Almeida, Thorsten Beck, Tobias Berg, Allen Berger, Lamont Black, Sapnoti Eswar, Jens Hagedorff, Paul Heidhues, Martin Hibbeln, Mark Humphery-Jenner, Vasso Ioannidou, Jan Krahnert, Simon Kwan, Bart Lambrecht, Christian Leuz, Ulrike Malmendier, Justin Murfin, Greg Nini, Michael Roberts, Jörg Rocholl, Raluca Roman, Catalina Stefanescu-Cuntze, Gregory Udell, Mark Wahrenburg, Andrew Winton, Robert DeYoung and participants at the Bank Structure Conference in Chicago, the American Finance Association Meetings in San Diego, the Financial Intermediation Research Society Conference in Dubrovnik, the European Finance Association Meetings in Copenhagen, the NYU Corporate Governance Seminar in New York, the Financial Management Association European Conference in Luxembourg, the Campus for Finance in Vallendar, the Brown Bag Seminar in Frankfurt, the Financial Management Association Meetings in Chicago, and the Workshop on Banking and Finance in Münster. Björn Imbierowicz gratefully acknowledges financial support from the Fritz Thyssen Foundation, and the Center for Financial Frictions (FRIC), grant no. DNR102.

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