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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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† Goethe University Frankfurt. Email: felix.freudenberg@hof.uni-frankfurt.de. Tel: +49 69 798 33700.
‡ Corresponding author: Copenhagen Business School, Finance Department and Center for Financial Frictions (FRIC), 2000 Frederiksberg (Denmark). Email: bi.fi@cbs.dk. Tel: +45 3815 3736.
* New York University, Stern School of Business. Email: asaunder@stern.nyu.edu. Tel: +1 212 998 0711.
§ University of Mannheim and ZEW. Email: steffen@zew.de. Tel: +49 30 21231 1544.
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