# CREATIVE DRAFTING OF BOND COVENANTS:

# A NEW ZEALAND CASE

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JEL classification: G18, G31, G33

Keywords: Bond Covenants, Bondholder Protection.

This Version: 25 January 2012

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## 1. INTRODUCTION

Since 2006, more than 51 New Zealand finance companies have failed and, as a result, investors have suffered extensive losses. It has been argued in previous literature that there is no single cause for the failure of finance companies, but that it resulted from several contributory factors, such as corporate governance, economic conditions, financial advisers, trustees and the Securities Commission (Yahanpath & Cavanagh, 2011). It has also been identified that finance companies had employed creative techniques, such as income smoothing, inflating profits, manipulating assets and liabilities, derivatives and hybrid financial instruments, to mislead investors (Yahanpath & Joseph, 2011). Accordingly, these factors raised questions relating to practices and the regulatory environment. Consequently, several changes were made to the New Zealand regulatory environment to overcome deficiencies highlighted by previous literature. Some of these were the establishment of the Financial Market Authority (FMA), the revision of Trustees' powers, and the Financial Advisers' Act 2008. There have also been changes in the accounting and auditing environment, such as the establishment of the External Review Board (XRB), to overcome accounting deficiencies. Thus, it could be stated that major steps have been taken by the government to have clear and robust laws for the securities markets, to give both domestic and international investors the confidence they need to invest in New Zealand, and to minimise potential future failure.

The focus of this study is on secured indenture issued by the finance companies in general, and the creative drafting of covenants in particular, as previous literature highlighted that there creative techniques and manipulation have been used by finance companies. Further, Yahanpath & Williams (2010) stated that creative techniques and manipulation are used for the purpose of deception, to make investments appear to be worthwhile. In the case of finance companies, one possible reason for using creative techniques and manipulation could be to attract further investments by creating a more favourable financial position. Therefore,

it is interesting to evaluate whether failed finance companies employed creative drafting techniques in their bond prospectuses, thus reducing bondholders' level of protection and resulting in the loss of their investments.

To our knowledge, there has not been any detailed study in the area of *creative drafting* of bond covenants. The motivation for the study also came from a recent New York case which identified that the imprecise drafting of bond contracts led to unsecured creditors having priority over secured creditors' claims (Lorose & Kohn, 2010). This study will add to the body of knowledge on bond covenants, by documenting some evidence of *creative drafting*, as well as ambiguities embedded in the covenants of failed finance companies.

The purpose of this paper is to investigate the degree of *creative drafting*[1] and *ambiguity*[2] of bond covenants embedded by failed finance companies in bond prospectuses. Therefore, we firstly identified the bond covenants (and their levels of protection) embedded by the failed finance companies. Secondly, we identified *whether* and *how* the failed finance companies employed creative drafting techniques and / or gained advantage from the ambiguous nature of their bond covenants, to mislead investors.

## 2. LITERATURE REVIEW

This section provides a brief discussion of the literature on bond covenants, which has been considerably expanded over the past decade. The majority of the papers examined the protection provided by bond covenants; the cost and benefits of the bond covenants from the firms' perspectives, and accounting methods used to avoid violation of debt covenants. This review helped to bring different pieces of research together, compare ideas, and identify the gap in the field of bond covenants.

### 2.1 Theoretical Framework

The theoretical concept underpinning this paper is agency theory. The agency theory has been well documented in previous literature (Sepe, 2010). Furthermore, the financial management fundamental of "higher risk and higher expected return" justifies the main area of concern and conflict between bondholders and shareholders. This is because the risk factor is always taken into consideration before an investment decision is made to determine whether the investment provides adequate return for the level of risk. Generally, the return to

[1] Embedding covenants in such a way that restrictions appear to provide adequate protection but, in fact, provide ineffective protection.

[2] Ambiguity can be defined as gaining an advantage from the deficiencies of legal obligations, such as measurement of finance leverage and asset value.

shareholders corresponds with the risk factor but, in a bondholder situation, the return is usually fixed. Thus, if the risk of the company increases in the future, it disadvantages bondholders disproportionately. Furthermore, the actions of management are guided by the objective of Shareholder Wealth Maximisation. Thus, management actions could result in the transfer of bondholder wealth to shareholders and an increase in credit risk.

Previous literature has evaluated the agency costs of debts, which include claim dilution, underinvestment, asset withdrawal, and asset substitution. Accordingly, the main cost of the agency problem is the negative impact on the value of the investment (i.e. investors' funds) as a result of the company's activities, such as further borrowing, the sale of assets, and risky investment. It can also be argued that these activities may lead to wealth transfers from the bondholders or lenders to shareholders. Bratton (2006) demonstrated the negative impact on the value of borrowings, following the foundation studies by Jensen and Meckling (1976), Smith and Warner (1979), and Myers (1976). He argued that cash received from asset withdrawal can be distributed as dividends; further borrowing by the company reduces the value of the prime borrowing, as it leads to leverage increase which also increases the prospect of payment default and the possibility of underinvestment, and decreases the value of the bondholders or creditors, due to high-risk investment. Thus, shareholders could gain the advantage of higher returns at the bondholders' expense.

Accordingly, restrictive covenants are included in bond indentures to provide protection to bondholders by giving them assurances regarding limitations on various forms of decapitalisation and the firm's risk. Furthermore, they give creditors the option of taking certain action when a covenant(s) is violated. Therefore, covenants reduce the agency problem. Covenants includes restrictions on investment policies, dividends policies, debt incurrence, asset sales, related parties' transactions, mergers and other covenants such as call options, and poison cuts.

Qi, Roth & Wald (2011) suggested that a firm with a stronger level of corporate governance uses more covenants to mitigate the agency costs. This provides evidence that companies do take appropriate actions to attract potential investors. However, *to what extent does the inclusion of bond covenants reduce the agency problem between shareholders and bondholders?* This adds to the motivation of the study, as the answer depends on the type of covenants included in the bond indentures.

## 2.2 Rationale for inclusion of Bond Covenants

Nash, Netter & Poulsen's (2003) findings suggest that firms with high growth are likely to design bond covenants to preserve flexibility in future financing activities. Thus, high-growth firms would not include payment-of-dividend and debt restrictions. These findings were also supported by Bradley & Roberts (2003) who further added that the decision to include a covenant and the corresponding promised yield are determined simultaneously. This is because firms consider the necessity of maintaining flexibility; for example, the ability to raise the funds to finance further projects. Nash, Netter, & Poulsen (2003) also claimed that covenants are significantly influenced by the investment opportunities of the firm.

Begley (1994) showed that firms base their choice of covenants on the perceived benefit and cost of the contractual restrictions provided in the bond indentures. Bradley and Roberts (2003) found that there is a trade-off between promised yield and the inclusion of restrictive covenants: the greater the restrictive covenants, the less likely the firm's management will be able to expropriate the bondholders' wealth and hence, the lower the required rate of return. Bratton (2006) further justified that the more bond covenants are presented, the more protected bondholders are, and the lower the costs to issuers.

Therefore, the literature indicate that companies consider the impact of covenants on the managerial flexibility and their possible cost-benefit trade-off, rather than their level of protection, before embedding the covenants. Further, bond covenants included by a company may be irrelevant, resulting in an ineffective protection to bondholders. Hence, the situation could promote and induce creative drafting of bond covenants, which is contrary to the ultimate objective of the covenants.

## 2.3 Accounting Choices – Inadequacy of Bond Covenants

Watts and Zimmerman (1986) argued that all actions are driven by self-interest and that individuals will act in an opportunistic manner to increase wealth. Their argument was based on the *Positive Accounting Theory* which predicts that firms which include bond covenants are likely to choose accounting methods to avoid the violation of bond covenants, as covenants are frequently written in the accounting numbers (Watts and Zimmerman, 1986). Begley (1990) further demonstrated the influence of accounting methods in his statement that they are positively related to both the existence of, and closeness to, accounting-based debt covenants. He concluded that, with accounting-based covenants, firms are more likely to choose income-increasing accounting methods to avoid their violation.

Mohrman (1996) suggested that the specifying of accounting methods in the bond contract, limits a manager's flexibility to change accounting methods and thereby increase the probability of financial covenant violation. Therefore, contracts often do not specify accounting methods as they are not cost-effective and are hard to manipulate in order to avoid their violation. Mohrman (1996) further argued that if a leading contract specifies an accounting method, managers could choose *aggressive accounting* to avoid violation and attempt to appear less risky to potential bondholders, while assuming that bondholders are unable to detect managers' earnings-management decisions. Hall & Swinney (2004) supported this argument.

These writers have highlighted that accounting methods or creative accounting are used to avoid violation of covenants, which undermines the purpose of bond covenants. This is another potential area of creative drafting that issuers may resort to, to gain advantage; ie, by embedding covenants, which are hard to enforce, or by changing accounting methods, a firm employs creative accounting.

## 2.4 Recent Literature in New Zealand

In New Zealand, most recently, four studies have been done in the broad area of bond covenants. Yahanpath & Bellard (2004) examined the covenants (and their effectiveness) that were offered by 15 issuers. They concluded that bondholders gain little protection from the protective covenants provided by issuers. Yahanpath & Ragg (2008) and Yahanpath & Koh (2010), using a large sample, further supported the findings of Yahanpath & Bellard (2004) and concluded that companies gave bondholders very little protection. They advised that investors should not rely on covenant protection provided by issuers. Furthermore, Yahanpath & Koh (2010) claimed that bondholders are not compensated for taking the additional risk and companies include weak covenants. Accordingly, the authors question *whether the inclusion of weak covenants is, to a degree, tantamount to creative drafting.*

Another area of creative drafting could be the use of covenants that leads to an ambiguous interpretation to gain advantage, such as to reduce the cost of debt and to disregard management restrictions. The ambiguous nature of the covenants is most likely to be accounting-based; eg, the misrepresentation of assets value and financial ratio, which are open to interpretation and which also provide opportunities for *creative accounting* to avoid violation, as highlighted above in other literature. Additionally, Yahanpath & Williams (2010) argued that there is a clear indication that ambiguity has a negative impact on bondholders' protection. They pointed out that there are areas which can be 'tweaked' to a

company's advantage, leaving investors in the dark as to what the true situation is; eg, an uncertain measure of assets and liability due to the 'book versus market-value' concept, and the wrong classification of leases.

Overall, the reviews of literature indicate that, so far, no dedicated study has been done on the *creative drafting* of bond covenants. However, it has highlighted that there is a potential area of creative drafting, which could be further examined and evaluated. Examples include weak covenants, ambiguous covenants, and ineffective covenants that are not relevant to business activities or investors' risk.

The remainder of the paper is organised as follows: Section 3 describes the methodology, selection of the sample and research design. Section 4 discusses the results based on the research design employed. Section 5 discusses the findings in relation to creative drafting and ambiguity of bond covenants. Finally, the conclusions are presented, which also discuss the possibility of further research and the limitations of this paper.

## 3. METHODOLOGY AND DATA COLLECTION

### 3.1 Methodology

The methodological procedures used in this paper constitute a qualitative research process. It includes historical case studies, such as bond prospectuses and other sources of evidence, to examine the degree of creative drafting employed by failed finance companies in their prospectuses. Yin (1994) suggested using multiple sources of evidence to ensure construct validity. Levy (1988) showed that multiple case studies follow replication logic. Stake (1995) argued that information generated by case studies would often resonate experientially with a broad cross-section of readers, thereby facilitating a greater understanding of the phenomenon. McGlion (2008) considered the contribution of the case study to the evidence base and argued that case-study methodology offers a creative and credible approach to help underpin contemporary practices.

### 3.2 Sample Selection

The sample of the companies is taken from the list of failed finance companies cited on Securities Commission New Zealand website. The sample of 25 companies was randomly selected from the entire list of the 51 failed finance companies, and includes companies still under investigation, companies with charges laid and companies that have been referred to other regulatory bodies.

More detailed information on bond covenants provided by the sample companies has come from each company's prospectus, which was obtained directly from the New Zealand Companies Office website. Bond prospectuses contained all the information which was provided to the potential investor – the company overview, a full set of audited financial statements, and a summary of the trust deed which includes bond covenants under the indenture, trustee duties and powers.

For the analysis, we considered the most recent prospectus of the secured bond issue before the company collapse. We excluded from the research those failed finance companies which had not issued secured bonds, and we randomly selected a sample of 25 finance companies which had issued secured bonds. The bond indentures examined in this research were issued from 2005 to 2010.

### 3.3 Research Design

The secured bond issues of randomly selected companies were examined. However, in order to identify and evaluate whether the bond covenants contained an element of creative drafting, it was necessary to examine each covenant separately from the protection it provided to bondholders. Therefore, a *Quality Assessment Matrix* was adapted from *Moody's Indenture Covenant Research and Assessment Framework* (Moody's Indenture Covenants, 2006), to assess the quality of each bond covenant individually in the bond contract, to identify the overall protection of the covenants in the bond contract, and to analyse whether the covenant(s) was creatively drafted with the intention of benefiting the company at the expense of investors.

The criteria to measure the degree of protection were based on the assessment considering the theoretical purpose of covenants (See: Appendix 1: Description of Bond Covenants and Rating Classification). In the quality assessment matrix, the measurements were based on:
***Strong -*** for protection which could completely achieve the actual purpose of the covenant;
***Modest -*** for a modest or limited protection relating to the purpose of the covenant;
***Weak -*** for protection which may or may not achieve the purpose of the covenant
The Quality Assessment Matrix does not include a creative drafting measure because a single covenant could be categorised as a weak covenant but might not be easily justified as creative drafting.

## 4. EMPIRICAL FINDINGS AND DISCUSSION

The findings are reported and discussed in two sections. The first part discusses the results on the strength of the bond covenants provided by the finance companies, utilising the *quality assessment matrix*, and also provides some contextual evidence for the second part which focuses on creative drafting and ambiguity of bond covenants. This study is limited to a detailed analysis of the business restriction covenant and the creative drafting methods employed in this particular covenant.

### 4.1 Strength of Bond Covenants

From 31 randomly selected failed finance companies a sample of 25 finance companies which had issued secured bonds was selected

**Figure 1: Classification and Strength of Covenants Provided by Finance Companies**

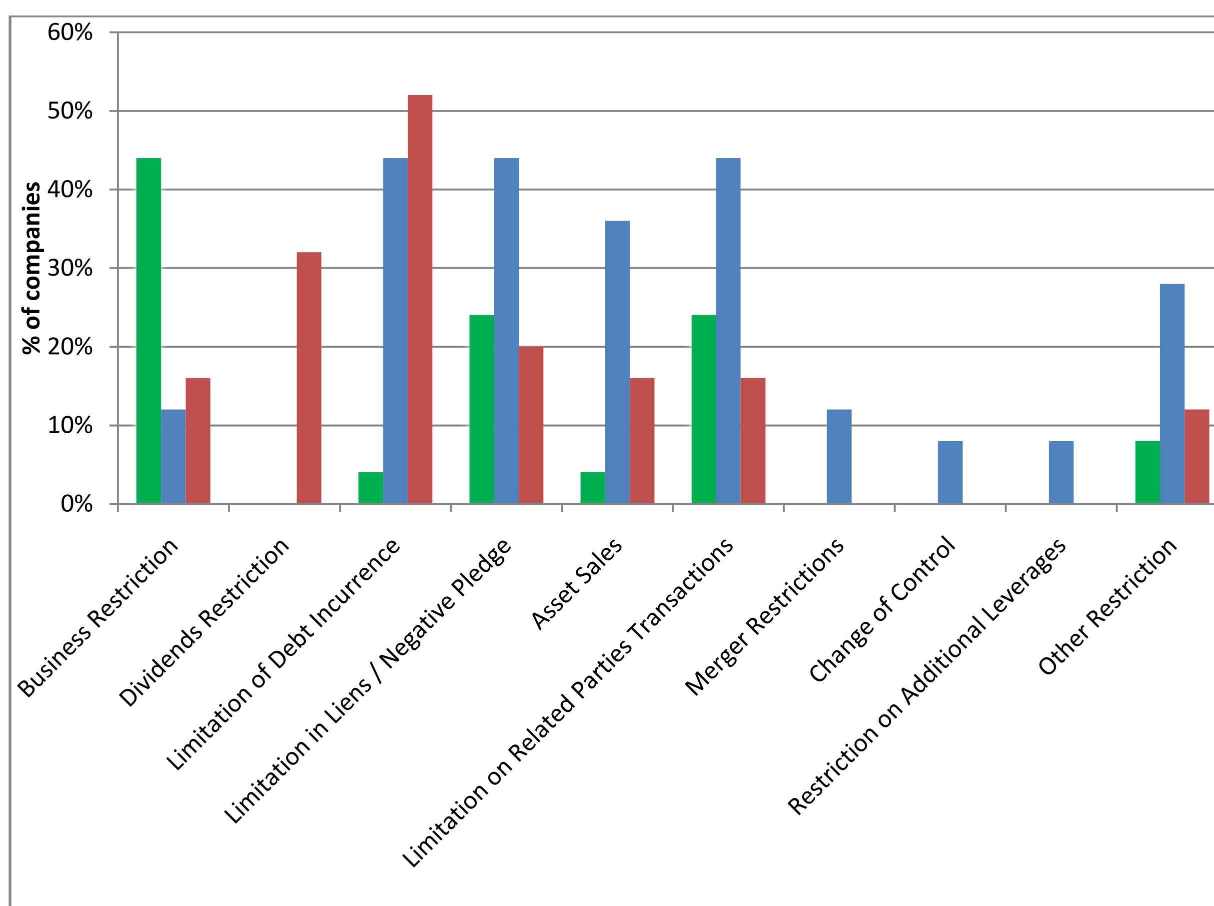



Figure 1 shows the covenants provided by the finance companies classified into ten different types and the level of protection provided to the bondholders. Accordingly, Figure 1 indicates that strong or modest protection was provided by the finance companies in Business Restrictions, Related Party transactions restrictions and Negative Pledges. On the other hand,

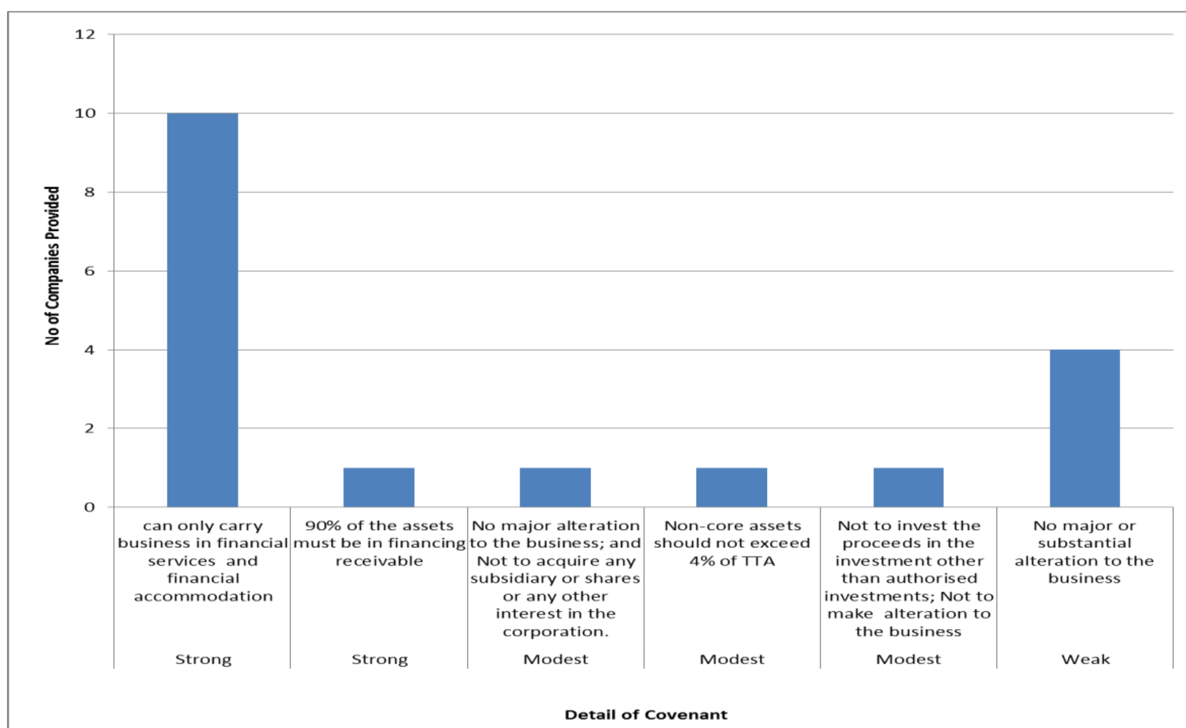
companies provided modest restriction in two covenants; namely, Assets Sales and Limitation of Debt Incurrence.

Although Figure 1 shows that finance companies provided some protection to the bondholders, it does not provide clear evidence[3], as companies provided strong or modest protection in a few covenants and weak in others, as shown in *Appendix 1*, which describes the quality of each individual covenant provided by the list of finance companies included in this research. The results of Appendix 1 suggest that finance companies provided strong protection through covenants in some areas of risk but limited or no protection in other areas. Accordingly, further evaluation is carried out to see whether creative drafting is evident.

## 4.2 Business Restriction Covenants

The analysis of the businesses' restriction covenants revealed that 44% of finance companies provided strong protection to bondholders in business restriction covenants. When further evaluation of business restriction covenants was carried out, it was found that most businesses provided strong protection to bondholders by restricting the business to specified business activities, as shown in Figure 2.

**Figure 2: Details of Business Restrictions Included by the Finance Companies**




[3] Although the study evaluated the strength of the covenants provided by the finance companies it did not provide a rating based on all the bond covenants provided by the companies.

Although the finance companies offered strong protection to bondholders by restricting business activities (i.e. they "cannot carry out business other than financial services and financial accommodation"), the question is; *"Does the presence of the business restriction covenant enhance the protection of the bondholders?"*

The answer to the question would be No! The main reason is that finance companies focus on expanding their lending (business) activities with no intention of expanding into other activities. This could be further justified by the fact that the finance companies were continually engaging in high-risk lending practices, which was one of the contributory factors in the finance companies' failure.

Accordingly, it could be an area of creative drafting, as the covenant should have restricted the management to investing in low-risk projects and/or engaging in low-risk lending practices with adequate provisions for bad loans (ie, quality of loans). However, this did not apply in the case of these finance companies, because the business restriction in debentures was not restricting management from high-risk investment, as shown in Figure 2. For example, in the case of Provincial Finance, the quality of the loan book was poor but, according to Wilson, Rose & Penfold (2010), Provincial Finance moved from its traditional base of providing finance for mortgages to first-home buyers, into used-car finance in South Auckland. Therefore, it can be argued that the business restriction in the finance company's situation does not actually enhance the protection of the bondholders. In fact, it defeats the purpose of this covenant, which is to restrict the management from other business activities that can increase the risk to investors.

In the case of Bridgecorp Ltd (BCL), there were no business restriction covenants embedded in the BCL bond indenture. The non-inclusion of a business restriction could be to provide flexibility in the use of the funds and to invest in other business activities, such as Barcoft Transaction. Thus, it could be argued that companies included business restrictions in their bond indentures for their own interests rather than for investors' protection. Furthermore, companies that included business restriction covenants were the ones with no intention of investing in other business activities but they also used creative drafting to provide ineffective protection to bondholders. Additionally, as highlighted by previous literature, bond covenants are also presented to reduce the cost of debt. Thus, the inclusion of business restrictions could also be an area of creative drafting with the intention of reducing the cost of the debt to mislead the investor into thinking that it reduces their risk.

### 4.3 Embedding of Weak Covenants

Wilson, Rose & Pinfold (2010) examined the New Zealand finance companies' failures, with an emphasis on the role of corporate governance. In their analysis of BCL, it was found that BCL funded their Australian operation from the funds raised in New Zealand through a series of related party transactions with its parent and parent subsidiary. In the case of BCL there was a covenant in the area of related party transaction which stated that *"loans made to Bridgecorp Holdings Ltd (BHL) by BCL will not exceed the 5% of total tangible assets"*. However, the related party transaction to fund the Australian operation exceeded the covenant limit. This provided some evidence of creative drafting. In fact, the creative drafting of this covenant helped BCL to avoid the violation of the covenant. This is because the trust deed definition of the related party was limited to the immediate owner of BCL. Thus, there was no limit on transactions with the parent's subsidiaries. It could be argued that the motive for not disclosing this limitation with the covenant was to hide the limitation of the covenant while disguising the strength of related party covenant protection.

BCL also embedded restrictions on related party transactions; "No related party transaction can occur except if the transaction is in ordinary course of business, for the proper value and on reasonable commercial terms". This provision does provide protection to the bondholder. On the other hand, we closely examined the provision which stated that "secured loans to non-charging subsidiary or in-substance subsidiary shall not exceed an amount equal to 22.5% of total tangible". This restriction does not provide adequate protection as the upper limit is significantly high. The debenture also included another restriction which stated that "total secured loans to clients shall not exceed 85% of the total security value of those loans", but it was silent about related party transactions. From this, it is evident that there is some degree of creative drafting in the case of BCL.

Similarly, from the evaluation, it is evident that structures of the total covenant package of prospectuses were likely to be creatively drafted, as most of the finance companies provided both weak and strong covenants which would not have enhanced the protection of the bondholder because, in some situations, strong covenants provided by the finance companies were in fact irrelevant and did not offer additional protection (Appendix 3). Consequently, the combined covenant package was not effective and this strategy misleads some investors.

### 4.4 Ambiguity of Bond Covenants

In addition to the creative drafting and the resulting ineffectiveness of bond covenants discussed above, it was also found that companies gained advantage from the ambiguous

nature of bond covenants. The prime example of such a covenant which is provided by many finance companies is in the restriction on asset sales, where companies stated that they *"cannot sell or transfer the major (substantial) part of the assets"*. From the general investor's perspective, one may argue that it does provide protection to the bondholder but, in effect, it does not provide any real protection. This is because, to minimise any violation of this covenant, it has to be justified that the major part of the asset is sold or transferred by the company. Consequently, it raises the question of what constitutes a major sale or transfer of assets. Thus, it could be argued that it is creatively drafted or that the covenant is ambiguous, as it lacks any enforceable conditions. Similar types of vaguely defined or creatively drafted covenants were also offered in other types of covenant which include business restrictions where companies stated that they *"cannot make major alterations to the business"*. Therefore, it could be argued that finance companies used vaguely defined covenants, as creative drafting techniques to gain advantage from their ambiguous nature.

Most of the accounting-based covenants were well defined. Many of them were based on the value of total tangible assets. However, the question is, *"Is the assets' value provided in the financial statements true and fair?"* The answer is debateable but, in the case of finance companies, the following examples and discussion provide substantial evidence that companies gained advantage from the ambiguity of the accounting-based covenants, such as by employing *creative accounting or aggressive accounting*.

Dominion Finance Group Ltd misstated the value of bad loans by recognising only $5-7 millions of bad debts, when the recommended "fair value" figure at balance date was upwards of $52.9 million. Dominion acknowledged this figure only after being placed into receivership by their trustee. Additionally, Provincial Finance also misstated the provision for bad and doubtful debts (Yahanpath, 2010). Lombard Finance and Investment had a portfolio of property loans worth $137 million. Interest was added to the loan balance to be paid in full on maturity, as opposed to regular instalments (PwC, 2008). The rapid decline in the property market resulted in the company overstating the assets but key stakeholders were deceived as the interest capitalisation was not disclosed and the assets were not impairment-tested. The resulting realisable value was 17-29% of the assets' book value ("Lombard investors", 2009). In the case of the Hanover Group, collapse was also due to the manipulation of the assets' value and interest capitalisation. The assets' value was $396.2 million but the value was significantly written-down. When "fair values" were revealed they were shown to be less than half the stated values: ie, from $396.2 million to $175 million (Parker, 2010). Therefore, finance companies have taken advantage of the ambiguity

associated with accounting standards and of the use of creative accounting to avoid violation of covenants.

## 5. CONCLUSION

The paper provides some evidence that finance companies employed creative drafting techniques to mislead investors. We found that some companies used a combination of weak with strong covenants to attract potential investors (ie, by indicating that covenants provided adequate protection). Additionally, the finance companies provided covenants based on the potential benefit associated with the covenants, with the intention of preserving their flexibility, rather than to provide protection to the bondholders. Consequently, the covenants included in bond indentures (such as business restriction) were not providing adequate protection to bondholders but could have been included to reduce the cost of debt in order to entice potential investors.

Another creative drafting technique employed by the finance companies was to include ambiguous covenants, which provided some flexibility to issuers' advantage and reduced the likelihood of covenant violation. This technique was employed by the finance companies by vaguely defining covenant restrictions. Finance companies also used *creative accounting* (such as overstating assets' value and understating provision for doubtful debt) to avoid the violation of the covenant, which provided some protection to the bondholders.

Overall, it could be stated that covenants presented in the finance companies' bond indentures were providing weak protection to bondholders. It could also be argued that bond covenants presented in the indentures to reduce the cost of debt and to attract investors, were mainly for the benefit of the company.

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## APPENDIX 1: DESCRIPTION OF BOND COVENANTS AND RATING CLASSIFICATION

### Business Restrictions

This covenant gives a bondholder the right to direct what a company can invest in and how much risk it may take. Effectively, it gives the bondholder the power to veto actions against investment policies that are not in their best interests (Yahanpath & Ragg, 2008). Thus, this covenant is minimise the risk of firms investing in high risk business activities, which would increase the issuer's risk and prevent a borrower's from not receiving the adequate return. The rating is provided based on the protection that covenant provides to the bondholders in terms of, company risk would not increase due to change in business activities. See *Table 1 Quality Rating of Key Covenants Provided by Finance Companies* shows the rating classifications of the key covenants provided by the finance companies.

### Dividends Restriction

The dividend covenant gives the bondholder the right that restricts an issuer's ability to make distribution to the shareholders, so covenant blocks the payment of the free cash flow to the shareholders. This covenant prevents asset withdrawals that may negative impact the lender's interest by locking in the firm assets at least equal in amount to those present at the time of the loan. Thus, enhances the lender's position during the term of the loan and discourages underinvestment (Bratton, 2006). Overall the covenant is to create a significant safeguard in the context of shareholder-creditors conflicts and the potential for shareholders activists to pressure management to reward shareholder's at creditors expense.

### Limitation on Debt Incurrence or Liquidity Requirement

The limitation on Debt Incurrence covenants provides protection to bondholders, as it restricts the firm's not to exceed certain liabilities ("Moody's Indenture Covenants Research", 2006). This covenant protects the bondholders against claim dilution and the risk of insolvency, as it will indirectly discourage risky investment as risk investments likely to increase the firm's liability.

### Limitation in Liens / Negative Pledge

A negative pledge covenant prevents the issuers from raising secured debt unless it provides security "rat-ably". Similarly, a limitation on liens operates like a negative pledge clause: it is meant to constrain a company's ability to create secured debt ahead of the existing security. Thus, it enhances the protection of the bondholders, as it prohibit the further security of assets and if the secured assets are used again, then no additional issue will rank ahead of the bonds

being assured. Thereby provide protection to bondholders against claim dilution ("Moody's Indenture Covenants Research", 2006).

### Assets Sales Restrictions

The assets sales restrictions limits the firm's ability to sell the assets, or limits the issuer's to use of the proceeds from the sale of assets to reduce the debt or re-invest in the remaining operations. The main purpose of this covenant is to provide assurance that these assets are provided as a protection for bondholders and cannot be sold and minimise the risk of asset substitution and asset withdrawal.

### Limitation on Related Parties Transactions

The related parties' transactions restriction limits the firm's ability to enter into a transaction with any related party such as subsidiary. The main purpose of this covenant is to provide assurance that the firm may not enter into the transaction, which may result in the transferring the value of the firm to the related party at bondholder's expense. Thus, this restriction protects the bondholders from claim dilution and underinvestment.

### Mergers Restrictions

The merger restrictions covenant limits the firm's ability to substantially merge or consolidate with another firm. The merger may negative impact on the value of the bondholders, due to the effect of the difference in variance rates or a difference in capital structures ("Moody's Indenture Covenants Research", 2006). The most finance companies has not presented this covenants in the bond contact, however, the companies which have provided this covenant has completely restricted the mergers. The covenant provided by the finance companies classified into modest rating, as it restricts the negative impact on the value of the bondholders. However, the strong covenant would have allowed the mergers opportunities that can enhance the value of the firm.

### Restriction on additional leverage

The restrictions on additional leverage covenant places a requirement on an issuing company to maintain a certain level leverage. The additional leverages provided by the failed finance companies include *"interest accrued not to exceed total accrued from the company investment"*. The rating of modest is provided to this covenant, as it reduces the risk of underinvestment and claim dilution.

## Change of Control

A change of control covenant protects the bondholder most directly from leveraged buyouts as well as from other situations where a change in ownership could damage credit quality ("Moody's Indenture Covenants Research", 2006). The most of finance companies have not provided this covenant in the bond prospectus, the companies which have provided included the restriction that *"exposure of single person or group not to exceed an amount equal to 35% of SH funds"*. This rating to modest is provided to this covenant as it adequately reduces the risk of change in ownership.

## Limitations on Sale and Leaseback

The main purpose of limitation on sales and leaseback transaction covenant is to restrict the firm's ability from selling the asset, in order to remove from the balance sheet and then leasing the asset back. This covenant also protects the bondholder against assist withdrawal and claim dilution, as the leaseback creates the burden in the forms of leases, as well as increasing fixed charges and reducing the assets pools available to bondholders. This covenant has not included in any finance company prospectus indenture ("Moody's Indenture Covenants Research", 2006).

## Other Restrictions

The other restriction contains the restrictions provided by the companies also further enhance the protection of the bondholders. The rating is given considering the restrictions and the extent to which it further enhanced the protection of the bondholder. The types of the other restriction provided by the failed finance companies include *"accounts receivable or financial receivable by any debtor not exceed $300,000 or 10% of the total tangible assets"*; or *"the amount must be secured by the first mortgage over the land; not to make one or series on loans in favour of borrowers which exceeds 10% of total tangible assets"*; and *"total secured loans to the clients not to exceed 85% of the total security value of those loans"*. The rating of strong is provided to these covenants because they provide significant protection to the bondholders in terms of the risk. However, the rating of weak is provided to *"accounts receivable by one debtor not to exceed 10% of total tangible assets subject to limitation that the amount owing to the charging group by a major retail finance company may not exceed either 35% of TTA or 70% of the total tangible assets"* of that major retail finance company.

## APPENDIX 2: STRENGTH CLASSIFICATION OF KEY COVENANTS INCLUDED BY FINANCE COMPANIES.

| ***Strength*** <br> ***Covenant*** | *Strong* | *Modest* | *Weak* | *Notes:* <br> *Rating Classification* |
|---|---|---|---|---|
| *Business Restriction* | Can only carry business other than financial services and financial accommodation | Not to acquire any subsidiary or shares or any other interest in the corporation other than the pursuant of any enforcement of the security right conferred by the company AND No major alteration to the business. | No major or substantial alteration to the business | *"To what extent the covenant restricts the business activities of the firm?"* |
| *Dividends Restriction* | Distribution to shareholders not to exceed the certain percentage of consolidated net income of the issuer or based on the debt to equity ratio; ***Not Present in Finance Companies*** | Distribution to shareholders not to exceed the certain percentage of consolidated net income of the issuer or based on the debt to equity ratio; ***Not Present in Finance Companies*** | No distribution when any secured debts become due. | *"Whether the covenant restricts an issuer's to make distribution and create a significant safeguard in the context of shareholder-creditors conflicts".* |
| *Limitation of Debt Incurrence* | Total liabilities not to exceed 85% of total tangible Assets | Total liabilities not to exceed 90% of total tangible Assets | Total liabilities not to exceed 95% of total tangible assets; ***OR*** Total liabilities not exceed *certain* times shareholders' funds. | *"To what extent the covenant restrict total claim on a company and protect bondholders against claim dilution and the risk of insolvency?"* |

| | | | | |
|---|---|---|---|---|
| *Limitation in Liens / Negative Pledge* | No Prior charges to be granted; ***OR*** Aggregate of Indentures Stocks and the amounts outstanding under the prior charges not to exceed the certain percentage of asset value based on the asset type AND Prior charges both existing and to be granted not to exceed certain 2.5% of the total tangible assets value. | Prior charges both existing and to be granted not to exceed certain 5% of the Total tangible assets value and considering the quality limitation of Debt Incurrence covenant. | Prior charges both existing and to be granted not to exceed certain 10% of the total tangible assets value and considering the quality limitation of Debt Incurrence covenant | *"Whether the covenant prevents the issuers from the raising the secured debts ahead of the existing security and provide protection against the reduction in the value"* |
| *Asset Sales* | Not to sell as a whole or as parts or proceeding of the assets sale is to be used for the debt reduction or reinvestment. | Not to sell as a whole or as parts compromising more than 25% of total tangible assets or 75% proceeding from the sale must be received in the cash and required the cash to be reinvested or used for debt reduction. | Not to sell or transfer the major part of the assets | *"Whether the restriction on the assets sale provides adequate assurance that sale of assets would not impact the value of the bondholders and minimise the asset substitution?"* |
| *Limitation on Related Parties Transactions* | Not to enter into any related party transaction unless it is in the ordinary course of the business and terms are at the arm's length as between unrelated parties and the value of the transactions not to exceed 5% of the total tangible assets. | No related party transaction except if the transaction is in ordinary course of business and terms are an arm's length as between two unrelated parties; However no related party transaction to exceed 20% of total tangible assets OR transaction secured by asset value 125%. | Related party transaction not to exceed an amount equal to 22.5% of total tangible assets | *"Does the covenant restriction protect the bondholders from underinvestment?"* |

## APPENDIX 3: STRENGTH OF COVENANTS PROVIDED BY THE FINANCE COMPANIES

| *Company Name* | *Business Restriction* | *Dividends Restriction* | *Limitation of Debt Incurrence* | *Asset Sales* | *Limitation in Liens / Negative Pledge* | *Limitation on Related Parties Transactions* | *Merger Restrictions* | *Change in Control* | *Restriction on Additional Leverages* | *Other Restriction* |
|---|---|---|---|---|---|---|---|---|---|---|
| Allied Nationwide Finance | Strong | Weak | Modest | Weak | Modest | Strong | Not Present | Not Present | Not Present | Not Present |
| Belgrave Finance | Strong | Weak | Modest | Modest | Modest | Strong | Not Present | Not Present | Not Present | Modest |
| Boston Finance | Strong | Weak | Weak | Modest | Modest | Strong | Not Present | Not Present | Not Present | Modest |
| Equitable Mortgages | Modest | Weak | Weak | Weak | Strong | Modest | Not Present | Not Present | Modest | Not Present |
| Finance & Leasing | Weak | Not Present | Weak | Modest | Modest | Modest | Not Present | Not Present | Not Present | Modest |
| South Canterbury Finance | Not Present | Not Present | Weak | Not Present | Modest | Weak | Not Present | Modest | Not Present | Not Present |
| Bridgecorp | Not Present | Not Present | Modest | Strong | Weak | Weak | Not Present | Not Present | Modest | Modest |
| Capital & Merchant | Strong | None | Weak | Weak | Weak | Modest | Not Present | Not Present | Not Present | Not Present |
| Clegg & Co | Strong | Weak | Modest | Modest | Not Present | Modest | Modest | Not Present | Not Present | Not Present |
| Five Star Consumer Finance | Strong | Weak | Weak | Modest | Modest | Strong | Modest | Not Present | Not Present | Modest |
| Nathans Finance | Weak | Not Present | Modest | Not Present | Strong | Weak | Not Present | Not Present | Not Present | Not Present |
| National Finance 2000 Ltd | Strong | Not Present | Strong | Not Present | Modest | Modest | Not Present | Not Present | Not Present | Modest |
| Western Bay Finance | Modest | Not Present | Modest | Not Present | Modest | Not Present | Not Present | Not Present | Not Present | Not Present |
| Provincial Finance | Strong | Not Present | Weak | Not Present | Weak | Strong | Not Present | Not Present | Not Present | Modest |
| Geneva Finance | Strong | Weak | Modest | Modest | Modest | Modest | Not Present | Not Present | Not Present | Strong |
| Kiwi Finance | Not Present | Not Present | Modest | Not Present | Modest | Not Present | Not Present | Not Present | Not Present | Not Present |
| Mutual Finance | Strong | Not Present | Modest | Modest | Modest | Strong | Not Present | Not Present | Not Present | Strong |
| All Purpose Finance | Not Present | Not Present | Weak | Modest | Modest | Not Present | Not Present | Modest | Not Present | Not Present |
| Strategic Finance | Weak | Not Present | Weak | Not Present | Modest | Modest | Not Present | Not Present | Not Present | Weak |
| Lombard Finance & Investment | Weak | Not Present | Modest | Not Present | Modest | Modest | Not Present | Not Present | Not Present | Weak |
| Hanover Capital | Strong | Weak | Weak | Modest | Not Present | Modest | Modest | Not Present | Not Present | Not Present |
| LDC Finance | Not Present | Not Present | Modest | Not Present | Modest | Modest | Not Present | Not Present | Not Present | Weak |
| Mascot Finance | Not Present | Not Present | Weak | Not Present | Weak | Not Present | Not Present | Not Present | Not Present | Not Present |
| Numerica Finance | Not Present | Not Present | Weak | Not Present | Weak | Modest | Not Present | Not Present | Not Present | Not Present |
| Compass Capital | Modest | Not Present | Weak | Weak | Strong | Weak | Not Present | Not Present | Not Present | Not Present |