PEI Alternative Insight

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UNDERSTANDING HIGH-YIELD BONDS

A complete guide for investors, issuers, banks and advisers

Milbank

Introduction

The following is an excerpt of chapters 6-11 from PEI's publication *Understanding High-Yield Bonds: A complete guide for investors, issuers, banks and advisers*. Authored by members of Milbank's Global Securities high-yield team, Chapters 6–11 are an essential reference guide for all professionals involved in originating, structuring/restructuring, issuing and investing in high-yield bonds, and drafting and negotiating the covenant package.

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The covenant package

6 High-yield covenants and terms – introductory concepts

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Introduction

High-yield (or junk) bonds are debt securities issued by companies rated below investment grade. These instruments have been a major source of liquidity in the mergers and acquisitions arena, most notably as a source of financing for leveraged buyouts by private equity sponsors and for issuers considered riskier than their investment-grade counterparts. Investors in these instruments are rewarded with higher coupons to compensate for the greater risk associated with these issuers, namely the risk of default and the potential loss of their entire investment.

Higher coupons alone are not enough, however, to attract investors to these debt securities. In addition, high-yield bonds include a package of customary covenants, which provide additional protections to bondholders by restricting issuers from engaging in a wide range of transactions and activities. While these covenants are standardised in many respects, they are also carefully negotiated and tailored to the specific business needs and situation of the issuer.

This chapter outlines some of the broader principles associated with the high-yield debt covenant package. The remainder of Section II then takes a closer look at how these covenants are drafted and negotiated as well as the practical implications for both issuers and bondholders.

Covenants: A brief overview

The quest for returns higher than sovereign and investment-grade corporate instruments drives the market for high-yield bonds. Safe investments (for example, short-term US treasury securities or government-insured savings accounts (at the extreme)) provide modest returns on investments, particularly in the current and recent past interest rate environment driven by aggressive monetary policy.

While investment-grade corporate bonds usually include a few covenants, they are typically very limited and primarily limit the amount of secured debt an issuer can incur that would be effectively senior to such investment-grade bonds. Issuers of high-yield debt, on the other hand, find that this money does not come without significant strings attached. As chapters 7 to 11 illustrate, high-yield covenants seek to regulate a wide range of issuer behaviour through the high-yield indenture, primarily activities that further increase the risk profile of the company issuing the high-yield bonds.

The high-yield indenture defines the rights of holders vis-à-vis the issuer and contains restrictions and prohibitions (though always with important exceptions) that issuers must operate under for the life of the bond. Under these indentures, a trustee is appointed to represent bondholders' interests and to facilitate various matters between the issuer and the bondholders (such as soliciting consents from bondholders to amendments the issuer would like to make to the indenture). While many corporate credit agreements contain covenants that require the borrower to maintain certain financial ratios (such covenants are referred to as 'maintenance covenants') to avoid being in default (for example, the issuer may be required to maintain a maximum debt-to-cash flow ratio in order to avoid a default), indenture covenants are typically only tested for compliance at the time an issuer wants to take a particular action (for example, borrow additional debt).

The most standard, and often the most negotiated, covenants place limitations on issuers' ability to:

- Incur additional debt.
- Grant liens on assets.
- Make certain investments, dividends, distributions and purchases of equity or junior debt (otherwise known as 'restricted payments').
- Sell assets.
- Enter into transactions with affiliates.

Each of these covenants serves a different purpose, but all seek to achieve one goal – to preserve the ability of issuers to pay interest and principal on the bonds when due.

Limitation on incurring additional debt

The obvious goal of the limitation on debt covenant, which is covered in greater detail in Chapter 8, is to limit the ability of an issuer to incur additional debt, unless it has sufficient cash flow (as measured by objective criteria) to service that debt. In addition, as discussed in Chapter 7, this covenant limits 'structural subordination' by restricting how much debt non-guarantor subsidiaries may incur.

Unlike investment-grade issuers, which typically have no limits on the amount of unsecured debt they are permitted to incur, there is a greater risk of default and bankruptcy for high-yield issuers. Bondholders therefore want to preserve the assets and limit any dilution from other debt claims of creditors of the issuer and its subsidiaries.

However, the limitation on incurring debt must be balanced against reality as most issuers need flexibility (sometimes significant flexibility for highly cyclical or capital-intensive businesses) to incur additional debt in order to operate in the ordinary course of business. As a result, baskets and exceptions (or 'carve-outs') to the limitation on debt covenant are negotiated based on the particular needs of the issuer over the term of the bond in light of its strategic business plan and activities in the ordinary course of business.

Negative pledge and limitation on liens

Closely aligned with the debt covenant, the limitation on liens covenant further restricts issuers from securing debt or other obligations with a pledge of collateral (also referred to as a 'lien').

Lien covenants in high-yield indentures typically permit issuers to pledge collateral or otherwise incur liens to secure debt or other obligations, but only to the extent an issuer equally and ratably secures the bonds under the indenture with the same collateral, subject in each case to a combination of standard and highly negotiated exceptions. This covenant is addressed in greater detail in Chapter 7.

The goal of this covenant is to minimise the amount of secured debt that can be incurred and that would be effectively senior to an unsecured high-yield bond or rank equal to a secured high-yield bond.

Restricted payments and asset sales

The limitation on restricted payments covenant is another highly negotiated negative covenant in a high-yield indenture and is addressed further in Chapter 9. Its purpose is to restrict the amount of cash or assets that leave the 'credit box' – comprised of the issuer and all of its subsidiaries that are guarantors or otherwise subject to the covenants (referred to as 'restricted subsidiaries') – in order to preserve the issuer's cash and assets that are available to repay the bonds. Restricted payments include the making of dividends, distributions, certain repurchases of equity or junior debt and certain investments.

The covenant is typically comprised of a 'builder basket', which grows if the issuer is profitable, as well as specifically negotiated carve-outs and baskets, including permitted investments. The carve-outs usually include a mix of activities, which are always allowed, such as dividends that were permitted to be paid when declared by the board, and negotiated baskets, which will vary based on the industry and type of bond being offered (for example, carve-outs to allow for certain dividends if the issuer is taken public).

Similar to the restricted payment covenant, the asset sale covenant protects the existing assets owned by the issuer from leaving the 'credit box'. Bondholders prefer to have these extra assets available to be sold, if necessary, to repay the bonds. As a result, a typical asset sale covenant is structured so that the proceeds from any sale of material assets have to be used to repay senior debt, to reinvest in the business within a certain period of time or to repurchase the bonds and any other equally ranking debt.

Limitation on transactions with affiliates

While often less debated than the covenants discussed above, the limitation on affiliate transactions covenant is still a primary focus for issuers, in particular for private equity sponsors, which may control other companies with which the issuer may transact business. This is because the covenant determines the terms an issuer must abide by in order to transact business with a person or entity that is an 'affiliate' of the issuer, typically defined as a person who controls or is under common control with the issuer. This covenant is discussed further in Chapter 10.

The goal of the covenant is to limit sweetheart deals, which might result in value leakage to insiders ahead of the repayment of bonds by giving an affiliate terms that are worse for the issuer (to the benefit of the affiliate) than what the issuer could otherwise obtain from an unrelated third party. Not only does the covenant require all but certain excepted transactions with affiliates to be on an arm's-length basis, it also typically provides for specified approvals if certain value thresholds have been met, ranging from board approval to the receipt of a fairness opinion from an independent financial advisor.

Call provisions

While the covenants serve to protect issuers' credit and ability to repay the bonds, the standard high-yield indenture also provides another protection for bondholders under the optional redemption provisions.

Unlike most credit facilities, which may be prepaid without penalty at any time, typical high-yield indentures provide for either a 'no-call' period or a 'make-whole' for the first few years of a bond's life, followed by declining redemption prices at a premium above par and at par in the final year (or two) of the bonds.

The no-call period essentially provides a blanket prohibition on the prepayment of the bonds (or at a make-whole) for a certain period of time. This guarantees that bondholders will continue to receive the coupon for that entire period.

A standard make-whole is designed to compensate bondholders for the loss of future interest payments as a result of an issuer's decision to prepay the debt during the no-call period. The amount is calculated based on a formula that attempts to approximate the lost opportunity costs to the bondholder as a result of the early retirement of the bonds. This feature is particularly important to issuers in declining interest rate periods and when their credit quality improves.

While investment-grade debt typically provides for a make-whole through maturity, the high-yield indenture usually only provides for such compensation in the first years of the bond. In the 'middle years', the high-yield indenture typically allows issuers to call the bonds at a premium, which is customarily structured to start at one-half the coupon of the bonds after half of the maturity has passed, with subsequent step-downs to par in the last year or two prior to maturity.

It is interesting to note that the redemption mechanics in high-yield bonds provide issuers with more flexibility than investment-grade issuers. Given the high cost of this type of capital, this structure enables issuers to refinance with more cost-effective sources of capital prior to maturity.

Conclusion

The above discussion provides a brief overview of a few of the complex covenants that form part of the high-yield indenture. The remaining chapters offer greater detail on each of the covenants and provide drafting and negotiating tips. As you read each chapter, it is important to keep in mind the principles behind each of the covenants as those goals will drive the negotiations. The high-yield indenture is not a form, but a complex instrument, which should be drafted carefully to preserve an issuer's ability to operate in the ordinary course of business while protecting bondholders from losing on their investment. ♦

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7 Protecting the bondholder's place in the queue – the role of subordination, anti-layering, liens, guarantees and time

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Introduction

A fundamental focus of high-yield bondholders is subordination in all its forms. Subordination is an assessment of how claims against an issuer by holders of its high-yield bonds rank with respect to the claims of an issuer's other stakeholders.[1]

High-yield bondholders primarily consider four types of subordination:

1. **Contractual subordination.** Debt of the issuer that is defined as 'senior indebtedness' under the bond documentation is expressly senior in right of payment to the bonds.
2. **Collateral subordination.** Debt of the issuer that is secured by collateral effectively ranks senior in right of payment to the bonds to the extent of the value of the collateral.
3. **Structural subordination.** Debt or other obligations (such as, trade credit) of the issuer's subsidiaries that are not guarantors or co-obligors of the bonds also effectively rank senior in right of payment of the bonds, which have no direct claim against the assets of those subsidiaries.
4. **Temporal subordination.** Debt or other obligations (such as, mandatorily redeemable preferred stock) of the issuer, which mature or are otherwise payable prior to the bonds, are also effectively senior in right of payment to the bonds.

Each of these types of subordination presents issues that affect the creditworthiness, potential recovery rate in a downside scenario, rating and valuation of the bonds and each is addressed through a number of customary high-yield bond indenture provisions, which are discussed further in this chapter.

Contractual subordination

In some jurisdictions (most notably in the United States), high-yield bonds can be issued in subordinated form, whereby the bonds contain contractual provisions that expressly subordinate the bonds in right of payment to other specified categories of 'senior indebtedness' of the issuer.

The most common form of subordinated high-yield bonds are senior subordinated bonds.

Generally, contractual subordination provisions provide that, in the event of a bankruptcy or similar restructuring, all senior indebtedness must be paid in full before

[1] Bondholders also consider other commercial and legal realities that affect claim value and ranking, such as the treatment of employee, pension and other similar claims under the laws applicable to the issuer's operations in various jurisdictions. This discussion focuses solely on contractual and legal matters that relate to secured and unsecured claims of debt and equity holders.

the subordinated notes can be paid. [An example of a customary subordination provision is shown in Example provision 1.]

Similarly, subordination provisions usually require the holders of the subordinated bonds to hold any distributions made to them in violation of the subordination provision in trust for the benefit of (and pay over such amounts to) the holders of senior indebtedness.

Negotiation points
The issuer's senior lenders usually review, comment and negotiate for specific protections in a bond's subordination provisions. For example, senior lenders often seek to:

- Limit the issuer's ability to satisfy the bondholders' claims with consideration other than, in some cases, new subordinated securities prior to satisfying the senior lenders' claims in full, in cash.
- Limit the ability of the issuer to issue 'Permitted Junior Securities' to subordinated bondholders only in satisfaction of all claims under the bonds.
- Include a standstill period and notice of acceleration (often five business days) to senior lenders prior to the effectiveness of any acceleration.
- Include the right to block interest and other payments on subordinated bonds if there is a default under the senior loan agreements (usually for up to 179 consecutive days).

Definition of senior indebtedness

Senior indebtedness is usually defined as all debt of the issuer that is not expressly junior or equal to the subordinated bonds in right of payment, but may also enumerate specific items of indebtedness (for example, indebtedness under a senior credit facility).

Generally, the definition of senior indebtedness (see Example provision 2) also expressly excludes certain obligations from the definition, such as obligations to trade creditors and tax authorities.

Negotiation points
Issuers and underwriters often negotiate the inclusion or exclusion of other types of debt from the definition of senior indebtedness. For example, issuers that are portfolio companies of private equity sponsors, in particular, will negotiate to change 'Affiliates' to 'Subsidiaries' so that debt owed to the sponsor can be treated as senior to the subordinated bonds, which bondholders might otherwise object to.

Example provision 1

Contractual subordination

The Issuer agrees, and each Holder by accepting a Senior Subordinated Security that the payment of all Obligations owing in respect of the Senior Subordinated Securities is subordinated in right of payment, to the extent and in the manner provided in this Article, to the prior payment in full of all existing and future Senior Indebtedness of the

Issuer and that the subordination is for the benefit of and enforceable by the holders of such Senior Indebtedness.

Upon any payment or distribution of the assets of the Issuer to creditors upon a total or partial liquidation or a total or partial dissolution of the Issuer or in a reorganisation, bankruptcy, insolvency, receivership of or similar proceeding relating to the Issuer or its property:

1. the holders of Senior Indebtedness of the Issuer shall be entitled to receive payment in full of such Senior Indebtedness in cash or Permitted Investments before Holders shall be entitled to receive any payment; and
2. until the Senior Indebtedness of the Issuer is paid in full, any payment or distribution to which Holders would be entitled but for this Article shall be made to holders of such Senior Indebtedness as their interests may appear, except that Holders may receive Permitted Junior Securities.

Designated senior indebtedness/ payment blockage periods

As discussed above, senior lenders often negotiate for special rights compared to other types of senior indebtedness. In this construct, an issuer is able to label certain senior debt as 'designated senior indebtedness' and thereby grant lenders under, or holders of, such debt certain additional rights and privileges.

For example, while it is typical to exclude from the definition of 'Senior Indebtedness' any debt that is incurred in violation of the indenture, designated senior indebtedness is often not excluded, even if incurred in violation of the indenture (see clause (e) in Example provision 2). Holders of designated senior indebtedness may also have other rights, such as the right to block payments to holders of subordinated bonds for a period of time if the issuer is in default on the designated senior indebtedness.

These so-called blocking rights are often an important feature, which bank lenders require in order to lend to an issuer on more favourable terms. [A typical payment blockage provision is shown in Example provision 3.]

Generally, holders of designated senior indebtedness are also afforded the right to block payments on the subordinated bonds for a period of time (typically 179 days) while the issuer is in default for reasons other than payment, if the holders of the designated senior indebtedness have a right to accelerate the maturity of that debt, but have not exercised that right. [A typical payment blockage period provision is shown in Example provision 4.]

Limitation on number of payment blockage periods

Generally, holders of designated senior indebtedness may only exercise payment blockage rights once during a consecutive 360-day period. However, senior lenders often negotiate for an additional blockage right if a holder of designated senior indebtedness, other than lenders under the bank facility, exercised the payment blockage. [Example provision 5 shows a typical limitation on number of payment blockage periods.]

In any event, holders of subordinated bonds generally expect a minimum number of days during any 360-day period (typically 181 days) during which an issuer may make payments on the subordinated bonds in the event of a non-payment default.

Holders of designated senior indebtedness are also usually entitled to notice from an issuer or trustee if the subordinated bonds are accelerated. Issuers also often agree to forego any payments on the subordinated bonds for a short period of time (for example, five days).

Example provision 2

Definition of senior indebtedness

Senior Indebtedness means:

1. all Indebtedness of the Issuer or any Guarantor and related Guarantees (including interest accruing on or after the filing of any petition in bankruptcy or similar proceeding or for reorganisation of the Issuer or any Guarantor (at the rate provided for in the documentation with respect thereto, regardless of whether or not a claim for post-filing interest is allowed in such proceedings)), whether outstanding on the Issue Date or thereafter Incurred;
2. any other Indebtedness of the Issuer or any Guarantor permitted to be incurred under the terms of this Indenture, unless the instrument under which such Indebtedness is incurred expressly provides that it is on parity with, or subordinated in right of payment to the Senior Subordinated Securities or any related Guarantee; and
3. all Obligations with respect to the items listed in the preceding clauses (1) and (2);

provided, however, that Senior Indebtedness shall not include:

a. any obligation of such Person to the Issuer or any of its Affiliates;
b. any liability for federal, state, local or other taxes owed or owing by such Person;
c. any accounts payable or other liability to trade creditors arising in the ordinary course of business;
d. any Indebtedness or other Obligation of such Person which is subordinate or junior in any respect to any other Indebtedness or other Obligation of such Person; or
e. that portion of any Indebtedness which at the time of Incurrence is Incurred in violation of this Indenture; provided that such Indebtedness shall be deemed not to have been Incurred in violation of this Indenture for purposes of this clause if such Indebtedness consists of Designated Senior Indebtedness, and the holders of such Indebtedness or their trustee, agent or representative (i) had no actual knowledge at the time of Incurrence that the Incurrence of such Indebtedness violated this Indenture and (ii) shall have received an Officer's Certificate to the effect that the Incurrence of such Indebtedness does not violate the provisions of this Indenture.

Example provision 3

Payment blockage

The Issuer shall not pay principal of, premium, if any, or interest on the Senior Subordinated Securities (or pay any other Obligations relating to the Senior Subordinated Securities) or make any deposit to defease or satisfy and discharge the Senior Subordinated Securities pursuant to this Indenture and may not purchase, redeem or otherwise retire any Senior Subordinated Securities (collectively, 'pay the Senior Subordinated Securities') (except in the form of Permitted Junior Securities) if either of the following occurs (a 'Payment Default'):

1. any Obligation on any Designated Senior Indebtedness of the Issuer is not paid in full when due (after giving effect to any applicable grace periods); or
2. any other default on Designated Senior Indebtedness of the Issuer occurs and the maturity of such Designated Senior Indebtedness is accelerated in accordance with its terms;

unless, in either case, the Payment Default has been cured or waived and any such acceleration has been rescinded or such Designated Senior Indebtedness has been paid in full; provided, however, that the Issuer shall be entitled to pay the Senior Subordinated Securities without regard to the foregoing if the Issuer and the Trustee receive written notice approving such payment from the Representatives of all Designated Senior Indebtedness with respect to which the Payment Default has occurred and is continuing.

Example provision 4

Payment blockage period

During the continuance of any default (other than a Payment Default) with respect to any Designated Senior Indebtedness of the Issuer pursuant to which the maturity thereof may be accelerated without further notice (except such notice as may be required to effect such acceleration) or the expiration of any applicable grace periods (a 'Non-Payment Default'), the Issuer shall not pay the Senior Subordinated Securities (except in the form of Permitted Junior Securities) for a period (a 'Payment Blockage Period') commencing upon the receipt by the Trustee (with a copy to the Issuer) of written notice (a 'Blockage Notice') of such Non-Payment Default from the Representative of such Designated Senior Indebtedness specifying an election to effect a Payment Blockage Period and ending 179 days thereafter. The Payment Blockage Period shall end earlier if such Payment Blockage Period is terminated:

1. by written notice to the Trustee and the Issuer from the Person or Persons who gave such Blockage Notice;
2. because the Non-Payment Default giving rise to such Blockage Notice is cured,

waived or otherwise no longer continuing; or
3. because such Designated Senior Indebtedness has been discharged or repaid in full.

Notwithstanding the foregoing provisions, unless the holders of such Designated Senior Indebtedness or the Representative of such Designated Senior Indebtedness shall have accelerated the maturity of such Designated Senior Indebtedness or a Payment Default has occurred and is continuing, the Issuer and related Guarantors shall be entitled to resume paying the Senior Subordinated Securities after the end of such Payment Blockage Period.

Example provision 5

Limitation on number of payment blockage periods

The Senior Subordinated Securities shall not be subject to more than one Payment Blockage Period in any consecutive 360-day period irrespective of the number of defaults with respect to Designated Senior Indebtedness of the Issuer during such period. In no event, however, shall the total number of days during which any Payment Blockage Period or Periods on the Senior Subordinated Securities is in effect exceed 179 days in the aggregate during any consecutive 360-day period, and there must be at least 181 days during any consecutive 360-day period during which no Payment Blockage Period is in effect.

Notwithstanding the foregoing, however, no default that existed or was continuing on the date of delivery of any Blockage Notice to the Trustee shall be, or be made, the basis for a subsequent Blockage Notice unless such default shall have been waived for a period of not less than 90 days (it being acknowledged that any subsequent action, or any breach of any financial covenants during the period after the date of delivery of a Blockage Notice, that, in either case, would give rise to a Non-Payment Default pursuant to any provisions under which a Non-Payment Default previously existed or was continuing shall constitute a new Non-Payment Default for this purpose).

Anti-layering covenants

An important feature of most subordinated bonds is an anti-layering covenant. This covenant prohibits issuers from incurring debt that is contractually subordinated to some senior indebtedness of the issuer, but that also seeks to be senior to the senior subordinated bonds.

Allowing for such debt permits the issuer to 'layer' the level of debt between the senior indebtedness, which the senior subordinated bondholders agreed to rank behind, but ahead of the senior subordinated bonds. [For the typical wording in an anti-layering covenant, see Example provision 6.]

Example provision 6

Anti-layering covenant

The Issuer will not, and will not permit any Guarantor to, directly or indirectly, incur any Indebtedness (including Acquired Indebtedness) that is subordinate in right of payment to any Senior Indebtedness of the Issuer or such Guarantor, as the case may be, unless such Indebtedness is either:

1. equal in right of payment with the Senior Subordinated Securities or such Guarantor's Guarantee of the Senior Subordinated Securities, as the case may be; or
2. expressly subordinated in right of payment to the Senior Subordinated Securities or such Guarantor's Guarantee, as the case may be;

provided that (i) unsecured Indebtedness will not be treated as subordinated or junior to Secured Indebtedness merely because it is unsecured and (ii) Senior Indebtedness will not be treated as subordinated or junior to any other Senior Indebtedness merely because it has a junior priority with respect to the same collateral.

Collateral subordination: Limitations on liens

Another way that debt can rank ahead of high-yield bonds or other unsecured debt is through the use of collateral.

For example, it is customary for high-yield issuers to have one or more credit facilities with various lending institutions. These credit facilities often include both a term loan and a revolving credit facility, which the issuer can access and repay over time to help manage working capital and other ongoing operational expenses.

Because bank facilities generally include a revolving facility, an issuer may depend heavily and frequently on this debt to be available to fund its business. Similarly, banks view revolving facilities as higher risk commitments because banks face uncertainty as to whether credit lines will be drawn and therefore must reserve capital in the event that these facilities are drawn. As a result, bank facilities (particularly revolving facilities) generally have the most lender-friendly provisions of an issuer's debt instruments, including the benefit of collateral from the borrower to secure payment on any debt outstanding under the credit facilities.

Sometimes this collateral includes substantially all of the assets of an issuer, but certain types of facilities (such as asset-based loans), are secured by specific short-term assets, such as inventory and accounts receivable.

Treatment in US

While the ranking of secured creditors above unsecured creditors is generally applicable in each jurisdiction around the world, the ability to grant security, value of security, ranking of security and ability to enforce on security vary widely by jurisdiction of the issuer's and guarantor's domicile and the location of their assets.

In the US, for example, in a bankruptcy or liquidation, secured lenders are given preference over unsecured lenders. Secured lenders, therefore, expect to recover more than unsecured lenders. As such, providing collateral to bank lenders gives the lenders an additional assurance of payment. In turn, this reduces the cost of secured bank facilities, which (unlike typical high-yield bonds) generally have a floating rate of interest that is expressed as a spread above a particular index (such as the London Interbank Offered Rate – LIBOR), which adjusts over time as market interest rates rise and fall.

Importantly, collateral is only as good as its market value and the benefits of being secured only apply to the extent of the value of the collateral. For example, if an issuer secures US$1 billion of indebtedness with the pledge of stock of its US subsidiaries and the value of that stock ultimately proves to be worth only US$800 million, then only $800 million of the debt holders' claim is treated as secured. The balance is deemed to be an unsecured claim and will recover on a pro rata basis with other unsecured debt.

Multi-tranched collateral structures

In recent years, collateral has been increasingly utilised (or 'spread') across several debt instruments by combining contractual subordination concepts and collateral through intercreditor agreements among different debt instruments. For example, one such structure provides a 'first lien' to an issuer's credit facilities and a 'second lien' to its high-yield bonds.

By spreading the collateral in this fashion, senior bank lenders continue to benefit in the first instance and take comfort from the contractual lien subordination provisions, which provide the junior lien holders access to the collateral only after the senior lienholders are paid in full.

This structure is also beneficial to secured high-yield bondholders because, even though they continue to be junior to the priority lien granted to the bank lenders, by having a second lien they are treated as secured lenders in a bankruptcy or liquidation and are entitled to be paid ahead of unsecured creditors, including senior but unsecured bonds or other general obligations of the issuer (such as general contractual obligations or even litigation awards). As a result, secured bonds offer the issuer a lower coupon than unsecured bonds.

If the bonds are to be secured, particular attention must be paid to the terms of any intercreditor agreements, particularly with respect to the presence or absence of limitations on amounts of relative priority debt that may be incurred and that may be subject to the rights and obligations of the intercreditor agreement.

Limitations on liens covenant

High-yield bonds also contain restrictive covenants that limit the ability of issuers to secure debt or other obligations ahead of the bonds.

The typical liens covenant (or negative pledge) provides that an issuer may not secure debt or, in some cases, other obligations unless it provides an equal and ratable lien to secure the bonds (except for specified permitted liens).

The negative pledge covenant is sometimes limited to just restricting the securing of debt (for an example, see the bracketed language in Example provision 7) rather than other obligations of the issuer. This effectively increases the amount of secured obligations that can rank ahead of the bonds (such as secured trade payables or leases to the extent these obligations are not treated as debt).

In subordinated bonds, this covenant is typically bifurcated in a way that securing senior indebtedness (as defined) does not require the subordinated bonds to be secured, but securing *pari passu* or junior debt does require the granting of an equal or senior lien, as applicable.

Negotiation points

There are two general approaches to lien covenants in high-yield bonds:

1. Follow the approach of most credit agreements and prohibit all liens other than those specified in a definition of permitted liens or diverge from the credit agreement approach and only prohibit liens that secure indebtedness, rather than any obligation.
2. Afford the issuer greater flexibility to secure certain obligations that do not constitute 'indebtedness', as defined in the indenture (for example, operating leases, contracts or performance bonds).

Example provision 7 illustrates both approaches by excluding or including the bracketed language.

Example provision 7

Negative pledge covenant

The Issuer shall not, and shall not permit any Guarantor to, directly or indirectly, create, incur, assume or suffer to exist any Lien (except Permitted Liens) on any asset or property of the Issuer or any Guarantor (including Capital Stock of a Restricted Subsidiary), whether owned at the Issue Date or thereafter acquired, or any income or profits therefrom, or assign or convey any right to receive income therefrom [that secures obligations under any Indebtedness or any related Guarantee] , unless the Securities or the Guarantees, as applicable, are equally and rateably secured or are secured by a Lien on such property, assets or proceeds that is senior in priority to such Liens.

Definition of permitted liens

The definition of permitted liens is extremely important as these liens are completely excluded from the limitations of the negative pledge covenant.

The definition has grown over time and can be extremely long, oftentimes duplicative and very often includes exclusions that are irrelevant to the issuer. This practice has grown, however, as bondholders tend to focus on only a very few of these exceptions, which relate specifically to types of indebtedness that may be secured. Investors focus much less on a growing list of 'boiler plate' minor and ordinary course exceptions. Relatively common boiler plate exceptions are set out in Example provision 8.

The far more important exceptions in the permitted liens definition, however, allow issuers to secure a certain amount of bank debt, capital leases, purchase money debt and secured debt existing at (or sometimes incurred in connection with the acquisition of) an acquired company. Some common exceptions for these types of debt are listed below:

1. Liens to secure any senior credit facilities.
2. Liens existing on the issue date.
3. Liens existing at the time a business or asset is acquired.
4. Liens securing intercompany indebtedness owed to an issuer or a subsidiary guarantor.
5. Liens securing foreign exchange, interest rate or commodity hedging obligations.
6. Liens to secure any refinancing of permitted secured debt.
7. Other liens securing a specified amount of debt (the 'general liens basket').

Negotiation points

The permitted liens definition is often one of the most highly negotiated terms in the high-yield covenant package and close attention to the specific business and legal requirements applicable to the issuer is merited.

Whether negotiating or analysing the permitted liens definition, it is important to look to the limitations on indebtedness covenant in order to assess what items of indebtedness the issuer is permitted to incur and whether that indebtedness can (or should) be capable of being secured.

To the extent that indebtedness can be incurred and secured, the position of the bondholders in a bankruptcy or liquidation will be diminished. That being said, issuers also require reasonable flexibility to operate and grow their business and secured debt is likely to be the form of capital with the lowest cost issuers have access to in order to finance operations and growth.

Attention must also be paid to a few matters to ensure that issuers do not inadvertently run afoul of the liens covenant and that the liens covenant is not inadvertently susceptible to overly generous interpretations.

For example, the definition of 'indebtedness' typically excludes items like interest and other obligations. This means issuers do not have to be concerned as to whether the payment of an administrative agent's fees or the accretion of original issue discount constitutes an incurrence of indebtedness for the purposes of the debt covenant. However, collateral agreements generally secure all such obligations, so the following sentence or something similar must be included to prevent an inadvertent default under the liens covenant:

> *For purposes of this definition, the term 'Indebtedness' includes all Obligations in respect of such Indebtedness.*

In addition to reviewing the debt covenant for whether particular debt can or should be capable of being secured, consideration should also be given to the specific types of property and assets that may be used as collateral.

Example provision 8

Definition of boiler plate permitted liens

'Permitted Liens' means, with respect to any Person:

1. pledges or deposits by such Person under workmen's compensation laws, unemployment insurance laws or similar legislation, or good faith deposits in connection with bids, tenders, contracts (other than for the payment of Indebtedness) or leases to which such Person is a party, or deposits to secure public or statutory obligations of such Person or deposits of cash or US government bonds to secure surety or appeal bonds to which such Person is a party, or for the payment of rent, in each case incurred in the ordinary course of business;
2. Liens imposed by law, such as carriers', warehousemen's and mechanics' Liens, in each case for sums not yet overdue for a period of more than 30 days or being contested in good faith by appropriate proceedings, or other Liens arising out of judgments or awards against such Person with respect to which such Person shall be proceeding with an appeal or other proceedings for review if adequate reserves with respect thereto are maintained on such Person's books in accordance with GAAP;
3. Liens for taxes, assessments or other governmental charges not yet overdue or payable or which are being contested in good faith by appropriate proceedings diligently conducted, if adequate reserves with respect thereto are maintained on such Person's books in accordance with GAAP;
4. Liens in favor of issuers of performance and surety bonds or bid bonds or with respect to other regulatory requirements or letters of credit issued pursuant to the request of and for the account of such Person in the ordinary course of its business; and
5. minor survey exceptions, minor encumbrances, easements or reservations of, or rights of others for, licenses, rights-of-way, sewers, electric lines, telegraph and telephone lines and other similar purposes, or zoning or other restrictions as to the use of real properties or Liens incidental to the conduct of the business of such Person or to the ownership of its properties which do not in the aggregate materially adversely affect the value of said properties or materially impair their use in the operation of the business of such Person.

Structural subordination

Structural subordination is one of the most complicated forms of subordination. It looks to the corporate structure in which an issuer resides to determine ranking.

Structural subordination arises when the issuer of debt, such as high-yield bonds, is a parent company to other subsidiaries and is particularly acute when an issuer is a holding company that does not have its own operations. In this situation, creditors of the subsidiaries (whether as lenders, bondholders, trade creditors or others) rank ahead of creditors of the parent.

This is because the subsidiary creditors have a claim against the assets of the obligor subsidiaries, whereas the parent company has only an equity claim as the owner of the subsidiaries' common stock. Similarly, if the subsidiary issues preferred stock to parties other than the parent, then the claims of those preferred stockholders rank ahead of the issuer's common stock claims.

For example, if a subsidiary produces a product that results in a products liability tort claim, in which the claimant successfully obtains an award against the subsidiary, then the claimant may enforce the judgment against the actual assets of the subsidiary. On the other hand, the parent has to rely on the ability of the subsidiary to pay the parent dividends or similar distributions in order to recognise the value of the subsidiary's assets.

In a bankruptcy or liquidation of the subsidiary, the tort victim's claim ranks ahead of the parent's claim because the parent holds equity of the subsidiary, while the tort victim holds a senior claim. As a result, creditors of the parent also only have the parent's equity interest in the subsidiaries to support their extensions of credit to the parent.

Reliance on structural subordination outside the US

In many jurisdictions, bondholders are uncomfortable relying on contractual subordination provisions because of the uncertain or negative nature of enforceability under statutory or judicial regimes.

In these jurisdictions, senior secured lenders often insist that unsecured high-yield bonds be incurred at a parent entity, while their debt is incurred at the operating company level. This means that they can rely on structural seniority to protect their claims on the operating company assets, as compared to the claims of the bondholders on the assets of the parent, which is usually just the common equity of the operating company.

Bond protections

High-yield bonds respond to structural subordination in three ways to help protect against structural subordination to the parent issuer's subsidiary obligors:

1. Upstream guarantees of the bonds from subsidiaries.
2. Limitations on the ability of subsidiaries to incur debt.
3. Limitations on the ability of subsidiaries to restrict their ability to pay dividends and similar distributions.

Subsidiary guarantees

Subsidiary guarantees are present in nearly all high-yield bonds in which an issuer has subsidiaries. This is because such a guarantee represents a direct debt claim against the subsidiary, ranking equally with other similar obligations of the subsidiary.

The indentures governing guaranteed high-yield bonds then govern both the release of these guarantees and the provision of additional guarantees in the event that new subsidiaries are formed or acquired. Example provision 9 shows a typical guarantee release provision.

High-yield indentures typically address the need for additional guarantees from newly formed or acquired subsidiaries in either an affirmative or negative covenant, which are discussed further below.

Practice point
Subsidiary guarantees from non-US subsidiaries that guarantee the debt of a US entity may result in significant adverse tax claims by the US Internal Revenue Service (IRS). While US tax counsel should be consulted in connection with any offering of high-yield bonds, it is particularly important to do so if guarantees are sought from non-US subsidiaries.

Affirmative covenants

Affirmative covenants are drafted to require any newly formed or acquired restricted subsidiary (often further limited to restricted subsidiaries organised in the US because of certain US federal income tax considerations that might treat guarantees from non-US subsidiaries as deemed dividends) to guarantee the bonds by executing a supplemental indenture to that effect.

Sometimes these covenants are further limited to only requiring the new or acquired subsidiary to guarantee the bonds if it guarantees other indebtedness of the issuer.

Negative covenant

The negative covenant derivation prohibits subsidiaries from providing guarantees of other indebtedness of the issuer (or another subsidiary guarantor), unless it also guarantees the bonds. [A typical negative additional guarantor covenant is shown in Example provision 10.]

If the bonds are to be registered with the US Securities & Exchange Commission (SEC) or if holders have registration rights, the issuer is required to comply with additional rules requiring additional financial information or, in limited instances, financial statements of guarantors in certain public reports.

Limitations on subsidiary debt

In addition, by limiting the amount of debt that subsidiaries can incur, high-yield bonds also limit the amount of debt that subsidiaries can incur that could rank effectively ahead of the bondholders' claims. This limitation does not, however, restrict the ability of subsidiaries to incur trade credit, nor does it offer protection from obligations other than debt, such as litigation awards or other contractual obligations (see the discussion in Chapter 8 regarding the limitations on indebtedness covenant).

Example provision 9

Guarantee release provision

A Guarantee by a Guarantor shall be automatically and unconditionally released and discharged, and no further action by such Guarantor, the Issuer or the Trustee is required for the release of such Guarantor's Guarantee, upon:

1. (a) any sale, exchange or transfer (by merger or otherwise) of (i) the Capital Stock of such Guarantor (including any sale, exchange or transfer), after which the applicable Guarantor is no longer a Restricted Subsidiary or (ii) all or substantially all the assets of such Guarantor, in each case, which sale, exchange or transfer is made in compliance with the applicable provisions of this Indenture;
   (b) the designation of any Restricted Subsidiary that is a Guarantor as an Unrestricted Subsidiary in compliance with the Limitations on Restricted Payments covenant of this Indenture and the definition of 'Unrestricted Subsidiary' hereunder; or
   (c) the exercise by Issuer of its Legal Defeasance option or Covenant Defeasance option in accordance with the terms of this Indenture or the Issuer's obligations under this Indenture being discharged in accordance with the terms of this Indenture; and
2. such Guarantor delivering to the Trustee an Officer's Certificate and an Opinion of Counsel, each stating that all conditions precedent provided for in this Indenture relating to such transaction have been satisfied.

Example provision 10

Negative additional guarantor covenant

The Issuer shall not permit any of its Restricted Subsidiaries, other than a Guarantor or a Foreign Subsidiary, to guarantee the payment of any Indebtedness of the Issuer or any other Guarantor unless:

1. such Restricted Subsidiary within 30 days executes and delivers a supplemental indenture to this Indenture providing for a Guarantee by such Restricted Subsidiary; and
2. such Restricted Subsidiary waives, and shall not in any manner whatsoever claim or take the benefit or advantage of, any rights of reimbursement, indemnity or subrogation or any other rights against the Issuer or any other Restricted Subsidiary as a result of any payment by such Restricted Subsidiary under its Guarantee;

provided that this Section shall not be applicable to any guarantee of any Restricted Subsidiary that existed at the time such Person became a Restricted Subsidiary and was not incurred in connection with, or in contemplation of, such Person becoming a Restricted Subsidiary.

Temporal subordination

The tenor of debt can impact its effective ranking. This simple concept actually drives many important decisions and can have significant pricing implications with respect to refinancing alternatives, which may be available to an issuer in relation to its outstanding indebtedness as well as to its ability to incur additional debt.

High-yield covenants address this risk by limiting the ability to refinance debt ahead of its maturity with other debt that matures sooner than the maturity of the debt being refinanced.

This is typically measured both by the actual scheduled maturity and the weighted average life to maturity for debt that has prepayment features. A typical refinancing provision is shown in Example provision 11, in which clauses (c) and (d) both relate to temporal subordination. If an issuer refinances debt other than in compliance with this provision, then it must treat the refinancing as both an incurrence of new indebtedness and as a restricted payment, which will require debt and restricted payment capacity under those covenants (see Chapters 8 and 9 regarding the limitations on indebtedness and restricted payments covenants). ♦

Example provision 11

Refinancing provision

[The Limitations on Restricted Payments covenant] shall not prohibit:

1. the defeasance, redemption, repurchase or other acquisition or retirement of Subordinated Indebtedness of the Issuer or any Restricted Subsidiary made in exchange for, or out of the proceeds of the substantially concurrent sale of, new Indebtedness of the Issuer or such Restricted Subsidiary, as the case may be, which is incurred in compliance with the Limitations on Indebtedness covenant of this Indenture so long as:

   a. the principal amount (or accreted value) of such new Indebtedness does not exceed the principal amount of (or accreted value, if applicable), plus any accrued and unpaid interest on, the Subordinated Indebtedness being so redeemed, repurchased, defeased, acquired or retired for value, plus the amount of any reasonable premium (including reasonable tender premiums), defeasance costs and any reasonable fees and expenses incurred in connection with the issuance of such new Indebtedness;
   b. such new Indebtedness is subordinated to the Securities or the applicable Guarantee at least to the same extent as such Subordinated Indebtedness so purchased, exchanged, redeemed, repurchased, defeased, acquired or retired for value;
   c. such new Indebtedness has a final scheduled maturity date equal to or later than the final scheduled maturity date of the Subordinated Indebtedness being so redeemed, repurchased, defeased, acquired or retired; and
   d. such new Indebtedness has a Weighted Average Life to Maturity equal to or greater than the remaining Weighted Average Life to Maturity of the Subordinated Indebtedness being so redeemed, repurchased, defeased, acquired or retired;...

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8 Limiting leverage – limitations on incurrence of indebtedness and sale and leaseback transactions

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Introduction

One of the most important covenants in a traditional high-yield covenant package is the limitation on incurring (or acquiring) additional debt.

Debt is typically defined to include only a few express types of obligations, such as debt for borrowed money, capital leases and deferred purchase price obligations. Example provision 1 provides a fairly typical construct of the definition, but there are variations. For example, the reference to Attributable Debt, which is a calculated amount based on the economic terms of sale and leaseback transactions, is often excluded if sale and leaseback transactions are not otherwise specifically addressed in the covenant package.

The definition also generally excludes items like interest and contingent and other contractual obligations. As a result, the payment of an administrative agent fee or the accrual of interest or accretion of original issue discount does not constitute an incurrence of additional indebtedness for the purposes of the debt covenant.

The debt covenant also restricts the issuance of 'Disqualified Stock' (generally defined as stock that, by its terms, can be required by its holder to be repaid prior to the maturity of the bonds) and preferred stock of restricted subsidiaries, both of which are equity securities that have debt-like features, such as preferential rights of payments and repurchase or put rights.

The purpose of the debt covenant is to limit the amount of claims the issuer's other creditors have so that the issuer's assets and cash flow are preserved for the benefit of the bondholders.

Example provision 1

Definition of indebtedness

'Indebtedness' means, with respect to any Person, any indebtedness of such Person (for clarification, excluding all accrued expenses and trade payables), whether or not contingent:

1. in respect of borrowed money;
2. evidenced by bonds, notes, debentures or similar instruments or letters of credit (or reimbursement agreements in respect thereof);

3. representing Capital Lease Obligations or Attributable Debt in respect of Sale/Leaseback Transactions;
4. representing all obligations of such Person issued or assumed as the deferred purchase price of property or services;
5. representing any Hedging Obligations;
6. to the extent not otherwise included, in respect of any Guarantee by such Person of any Indebtedness of any other Person; or
7. in respect of Indebtedness of any other Person secured by a Lien on any asset of such Person;

in each case, if and to the extent any of the preceding items (other than letters of credit, Attributable Debt and Hedging Obligations) would appear as a liability on a balance sheet of such Person prepared in accordance with GAAP.

Ratio debt

The typical covenant contains a prohibition against incurring debt unless a certain credit ratio is satisfied. The credit ratio is usually a ratio that allows debt to be incurred if, on a pro forma basis, the issuer's cash flow or EBITDA[1] will be at least twice as much as aggregate interest and similar expenses (known as a 'coverage ratio'). However, for companies in certain highly capitalised industries (for example, telecommunications), the custom is to use a credit ratio permitting incurrence of debt if, on a pro forma basis, the issuer's total outstanding indebtedness will be less than a stated multiple of cash flow or EBITDA (known as a 'leverage ratio'). Indebtedness that is incurred pursuant to a credit ratio is referred to as 'ratio debt'.

Incurrence of ratio debt by subsidiaries

As discussed in Chapter 7, bondholders are concerned about structural subordination and limiting the ability of subsidiaries, which do not guarantee the bonds, to incur indebtedness. As such, the standard formulation of the debt covenant only permits the issuer and subsidiary guarantors to incur ratio debt. However, in certain cases, bondholders have been willing to accept a construct that permits non-guarantor subsidiaries to incur ratio debt, usually subject to an express cap on the amount of ratio debt such non-guarantor subsidiaries may incur in the aggregate.

An illustration of the standard language for a debt service credit ratio under the indebtedness covenant is shown in Example provision 2. Inclusion of the bracketed clause "that Guarantee the bonds" and excluding the bracketed further proviso results in the formulation that prohibits non-guarantor subsidiaries from incurring ratio debt.

Definitions

The basic building block in determining ratio debt availability is found in the definition of the credit ratio (for example, the 'Fixed Charge Coverage Ratio' in Example provision 2),

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[1] EBITDA is often used as a proxy for measuring the cash flow available to service debt and stands for earnings before interest, tax, depreciation and amortisation expenses. EBITDA will be defined and is probably the most highly negotiated and varied definition in high-yield indentures from issuer to issuer, often including additional adjustments for a wide range of non-cash, non-recurring or other expenses or income. This definition is discussed in greater detail on page 81.

Example provision 2

Limitation on additional debt covenant and ratio debt

The Issuer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, create, incur, issue, assume, guarantee or otherwise become directly or indirectly liable, contingently or otherwise (collectively, 'incur' and collectively, an 'incurrence') any Indebtedness (including Acquired Indebtedness), and the Issuer will not issue any shares of Disqualified Stock and will not permit any Restricted Subsidiary to issue any shares of Disqualified Stock or Preferred Stock; provided, however, that the Issuer may incur Indebtedness (including Acquired Indebtedness) or issue shares of Disqualified Stock, and any of its Restricted Subsidiaries [that Guarantee the bonds] may incur Indebtedness (including Acquired Indebtedness), issue shares of Disqualified Stock and issue shares of Preferred Stock, if the Fixed Charge Coverage Ratio on a consolidated basis for the Issuer and its Restricted Subsidiaries' most recently ended four fiscal quarters for which internal financial statements are available immediately preceding the date on which such additional Indebtedness is incurred or such Disqualified Stock or Preferred Stock is issued would have been at least 2.00 to 1.00, determined on a pro forma basis (including a pro forma application of the net proceeds therefrom), as if the additional Indebtedness had been incurred, or the Disqualified Stock or Preferred Stock had been issued, as the case may be, and the application of proceeds therefrom had occurred at the beginning of such four-quarter period; [provided, further, that Restricted Subsidiaries that are not Guarantors may not incur Indebtedness or issue Disqualified Stock or Preferred Stock if, after giving pro forma effect to such incurrence or issuance (including a pro forma application of the net proceeds therefrom), more than an aggregate of US$[XX] million of Indebtedness or Disqualified Stock or Preferred Stock of Restricted Subsidiaries that are not Guarantors would be outstanding pursuant to this paragraph].

which is further comprised of critical definitions, such as EBITDA (sometimes referred to as 'consolidated cash flow').

For example, Fixed Charge Coverage Ratio is typically defined as EBITDA for the four fiscal quarters preceding the proposed debt incurrence divided by the issuer's 'Fixed Charges' (sometimes referred to as 'Consolidated Interest Expense') for that period, where Fixed Charges is defined to include interest expense, dividends on preferred stock and similar expenses.

EBITDA

EBITDA or cash flow definitions start with the basic concept of adding back to earnings (or consolidated net income) interest, tax, depreciation and amortisation expenses. However, in almost all cases, the definitions also contain additional add-backs and carve-outs, which are highly negotiated because each additional dollar of EBITDA results in the issuer being able to incur a multiple of that dollar of additional indebtedness.

The majority of these add-backs relate to non-cash and/or non-recurring items, which are intended to approximate actual cash available on a normalised basis (or 'run rate') by adding or removing unusual occurrences, non-cash items and certain types of expenses or income that may distort an issuer's ongoing cash-flow generation ability.

Example provision 3

Definition of EBITDA

'EBITDA' for any period means Consolidated Net Income, plus or minus the following to the extent deducted or added in calculating such Consolidated Net Income:

1. all income tax expense of the Issuer and its Restricted Subsidiaries on a consolidated basis; plus
2. Consolidated Interest Expense; plus
   depreciation and amortisation expense of the Issuer and its Restricted Subsidiaries (excluding amortisation expense attributable to an expense paid in cash in a prior period) on a consolidated basis; plus
3. all other non-cash charges of the Issuer and its Restricted Subsidiaries (excluding any such non-cash charge to the extent that it represents an accrual of or reserve for cash expenditures in any future period) on a consolidated basis; plus
4. [the amount of any restructuring charge or reserve deducted (and not added back) in such period in computing Consolidated Net Income, including any one-time costs incurred in connection with acquisitions after the Issue Date and costs related to the closure and/or consolidation of facilities;] plus
5. [the amount of net cost savings projected by the Issuer in good faith to be realised as a result of specified actions taken or to be taken(calculated on a pro forma basis as though such cost savings had been realized on the first day of such period), net of the amount of actual benefits realised during such period from such actions; provided that (a) such cost savings are reasonably identifiable and factually supportable, (b) such actions have been taken or are to be taken within [XX] months after the date of determination to take such action, (c) no cost savings shall be added pursuant to this clause (5) to the extent duplicative of any expenses or charges relating to such cost savings that are included in clause (3) above with respect to such period and (d) the aggregate amount of cost savings added pursuant to this clause (5) shall not exceed US$[XX] million for any four consecutive-quarter period;] minus
6. non-cash gains increasing Consolidated Net Income of such Person for such period, excluding any non-cash gains to the extent they represent the reversal of an accrual or reserve for a potential cash item that reduced EBITDA in any prior period; plus or minus, as applicable,
7. any net gain or loss resulting in such period from currency translation gains or losses related to currency measurements of Indebtedness,

in each case for such period.

The starting point to any calculation of EBITDA is Consolidated Net Income (CNI). Like EBITDA, CNI is also a highly negotiated definition in a high-yield transaction because it not only forms the basis of the EBITDA calculation but it is also the starting point to calculate availability under the builder basket in the restricted payment covenant, which is discussed further in Chapter 9.

As a general rule, CNI starts with GAAP (Generally Accepted Accounting Principles) net income and deducts certain items such as:

- Income from unrestricted subsidiaries (other than cash actually distributed by such subsidiaries during the relevant period).
- After-tax extraordinary, non-recurring or unusual gains, losses, income, expenses and charges.
- Transaction fees, costs and expenses incurred in connection with the consummation of any transaction outside of the ordinary course of business.
- All non-cash impairment charges and asset write-ups, write-downs and write-offs.
- Non-cash expenses associated with or resulting from stock option plans, employee benefit plans or agreements or post-employment benefit plans or agreements.
- A number of other standard and specifically negotiated exclusions.[2]

Recently, both issuers and bondholders have spent much attention on add-backs related to synergies associated with actions that have been taken (or that will be taken) by the issuer that the issuer expects will have a positive effect on future EBITDA. An example of this is provided in clause (5) of Example provision 3.

Specific attention is often paid to this particular prong of the EBITDA definition since it involves estimates by the issuer and, as a result, indentures often require that such synergies as anticipated to be realised within a certain period of time (typically 12 to 18 months) and that any such synergies are capped.

Bondholders often also require that the calculation be based on objective criteria (for example, permitted by certain accounting standards for preparing pro forma financial statements) and submitted to the indenture trustee with a certificate from an officer of the issuer attesting to its calculation in conformity to the provisions of the indenture.

Consolidated Interest Expense

Consolidated Interest Expense is both the denominator for the coverage ratio and an add-back to the definition of EBITDA. Consolidated Interest Expense is generally defined to include consolidated interest expense determined under GAAP, plus cash dividends on preferred stock and other similar expenses of the issuer and its restricted subsidiaries.

[2] Because CNI is also used to determine an issuer's availability to make restricted payments, issuer's often seek to reflect the non-cash, non-recurring and other add-backs described above into the definition of CNI, thereby increasing CNI and increasing the ability to make restricted payments.

Permitted indebtedness in addition to ratio debt

High-yield indentures always permit issuers to incur certain types and amounts of indebtedness (referred to as 'permitted indebtedness'), even if an issuer is unable to incur ratio debt at the time.

Permitted indebtedness includes both carve-outs to the prohibition on incurring debt and 'baskets' for types of debt that are subject to limitations in amount and other conditions.

Baskets can be drafted as capped amounts or as a 'grower' basket, which has the potential to increase if the issuer grows with respect to the reference metric (which is often consolidated total assets).

Credit facility basket

The basket that permits an issuer to incur debt under its credit facility is one of the most important baskets for issuers. This is because it allows for a typically large amount of debt to be incurred and secured, almost always ranking senior to the bonds. An example of this basket is provided in Example provision 4.

The definition of 'Credit Agreement' is often broadly drafted and, in certain cases, allows an issuer to incur a range of debt types beyond typical bank loans, including capital markets indebtedness and securitisations (as reflected in the definition provided in Example provision 4).

While all indentures permit certain debt baskets to be refinanced, the standard carve-out for refinancing indebtedness does not include the credit facility basket. Instead, the ability to refinance debt incurred under the credit facility basket is self-contained within the definition of Credit Agreement, which provides that such an agreement includes amendments, restatements, modifications, supplements, renewals and replacements.

Example provision 4

Credit facility debt basket and definition of Credit Agreement

In addition to ratio debt, so long as no Default has occurred and is continuing, the Issuer and the Restricted Subsidiaries shall be entitled to Incur any or all of the following Indebtedness:

1. Indebtedness of the Issuer or any Restricted Subsidiary Incurred under a Credit Agreement and the issuance and creation of letters of credit and bankers' acceptances thereunder (with undrawn trade letters of credit and reimbursement obligations relating to trade letters of credit satisfied within 30 days being excluded, and bankers' acceptances being deemed to have a principal amount equal to the face amount thereof) in an aggregate amount up to the greater of (a) US$[XX] million and (b) [XX]% of Total Assets at any time outstanding;…

'Credit Agreement' means, with respect to the Issuer or any of its Restricted Subsidiaries, one or more debt facilities or other financing arrangements (including, without limitation, commercial paper facilities or indentures) providing for revolving credit loans, term loans, letters of credit or other long-term indebtedness, including notes, mortgages, guarantees, collateral documents, instruments and agreements executed in connection therewith, and any amendments, supplements, modifications, extensions, renewals, restatements or refundings thereof and any indentures or credit facilities or commercial paper facilities that replace, refund or refinance any part of the loans, notes, other credit facilities or commitments thereunder, including any such replacement, refunding or refinancing facility or indenture that increases the amount permitted to be borrowed thereunder (provided that such increase in borrowings is permitted under 'Certain Covenants—Limitation on Incurrence of Indebtedness and Issuance of Disqualified Stock and Preferred Stock'), alters the maturity thereof or adds Restricted Subsidiaries as additional borrowers or guarantors and whether by the same or any other agent, lender or group of lenders.

Existing debt and bonds baskets

High-yield indentures will carve-out and permit any existing debt of an issuer and the bonds being issued.

Particular attention must be paid to the drafting of this carve-out to ensure that it only includes the bonds being issued at the time because most indentures are 'open' and permit an issuer to issue additional bonds in the future with the same terms.

This feature allows the issuer the flexibility to simply tack-on additional bonds to the same class, which can be achieved in smaller denominations than an issuance of a new class of bonds. However, the bonds carve-out should only cover the bonds issued on the date of the indenture and require that additional bonds be incurred under a different provision of the covenant, such as ratio debt. Otherwise, the provision could be misinterpreted as permitting an unlimited amount of bonds to be issued.

Purchase money debt/capital lease basket

The purchase money debt basket allows issuers to incur a certain amount of debt in connection with the acquisition of assets or through capital leases (and the lien covenant typically allows such debt to be secured).

There is nearly always a cap to the amount of debt that can be incurred under this carve-out, but this basket is often drafted as a 'grower' basket. Attention should also be paid to how purchase money indebtedness covered by this basket is defined or expressed. This is because it is often drafted broadly to permit this basket to be used for acquisition-related debt in connection with M&A activity that would not be encompassed by traditional concepts of purchase money debt. Example provision 5 illustrates the narrower approach.

Example provision 5

Purchase money debt basket

In addition to ratio debt, so long as no Default has occurred and is continuing, the Issuer and the Restricted Subsidiaries shall be entitled to Incur any or all of the following Indebtedness:…

2. Indebtedness (including Capitalised Lease Obligations, but excluding Acquired Indebtedness) of the Issuer or a Restricted Subsidiary Incurred to finance (whether prior to or within 90 days after) all or any part of the cost of the purchase, lease, construction or improvement of any property, plant or equipment used or to be used in the business of the Issuer or such Restricted Subsidiary, and any Indebtedness of the Issuer or a Restricted Subsidiary which serves to refund or refinance any Indebtedness Incurred pursuant to this clause (2) in an aggregate outstanding principal amount which, when taken together with the principal amount of all other Indebtedness Incurred pursuant to this clause (2) and then outstanding, will not exceed the greater of (x) US$[XX] million and (y) [XX]% of Total Assets at any time outstanding;

Other acquisition debt baskets

High-yield bonds are often issued by portfolio companies of private equity sponsors or other companies, which are seeking to grow through acquisitions. As such, permitted debt often includes a basket for debt incurred to finance acquisitions. There are various formulations of these baskets, but they are generally either limited to a capped amount (possibly expressed as a grower basket) or tied to a size that is permitted by, or would improve, the credit ratio necessary to incur ratio debt. Example provision 6 shows the wording of this type of basket.

Example provision 6

Acquisition debt basket

In addition to ratio debt, so long as no Default has occurred and is continuing, the Issuer and the Restricted Subsidiaries shall be entitled to Incur any or all of the following Indebtedness:…

3. Indebtedness of Persons Incurred and outstanding on the date on which such Person became a Restricted Subsidiary or was acquired by, or merged into, the Issuer or any Restricted Subsidiary (whether or not Incurred (i) to provide all or any portion of the funds utilised to consummate the transaction or series of related transactions pursuant to which such Restricted Subsidiary became a Restricted Subsidiary or was otherwise acquired by the Issuer or (ii) otherwise in connection with, or in contemplation of, such acquisition); provided, however, that at the time such Person is acquired, either:

a. the Issuer would have been able to Incur US$1.00 of additional Indebtedness pursuant to the first paragraph of this covenant after giving effect to the Incurrence of such Indebtedness pursuant to this clause (3); or
b. the Fixed Charge Coverage Ratio would be greater than immediately prior to such acquisition;…

Contribution debt basket

Permitted debt often, particularly for portfolio companies of private equity sponsors, includes a basket for 'Contribution Indebtedness'. This basket permits the issuer to incur additional debt in an amount equal to the aggregate amount of cash contributions made to the issuer's equity capital after the issue date.

The definition of 'Contribution Indebtedness' sometimes requires that such debt be incurred within a specified period of time after the cash contribution and that it is designated as such by the issuer at the time of incurrence.

General and other debt baskets

In addition to the more specific carve-outs discussed above, permitted debt nearly always permits the issuer to incur a specified, capped amount of additional debt, generally thought of as a rainy day or emergency basket.

The high-yield indenture also includes a number of other exceptions and carve-outs to the debt covenant including:

- Refinancing debt.
- Intercompany debt.
- A basket for the debt of non-guarantor subsidiaries (or foreign subsidiaries).
- The incurrence of guarantees of ratio debt and permitted debt.

Most high-yield indenture debt covenants also provide issuers with the ability to classify, and later reclassify, the basis for which it incurred items of debt. For example, an issuer may incur an item of permitted debt under a capped basket because it does not have the

Example provision 7

Limitation on sale/leasebacks

The Issuer will not, and will not permit any of its Restricted Subsidiaries to, enter into any Sale/Leaseback Transaction unless:

1. the Issuer or such Restricted Subsidiary could have Incurred Indebtedness in an amount equal to the Attributable Indebtedness in respect of such Sale/Leaseback Transaction pursuant to the covenant described under 'Certain Covenants–Limitation

on Incurrence of Indebtedness and Issuance of Disqualified Stock and Preferred Stock';
2. the Issuer or such Restricted Subsidiary would be permitted to create a Lien on the property subject to such Sale/Leaseback Transaction under the covenant described under 'Certain Covenants—Limitation on Liens'; and
3. if the Sale/Leaseback Transaction is an Asset Sale, all of the conditions of the Indenture described under 'Certain Covenants—Limitation on Asset Sales' are satisfied with respect to such Sale/Leaseback Transaction, treating all of the consideration received in such Sale/Leaseback Transaction as Net Available Cash for purposes of such covenant.

ability to incur ratio debt at the time. Then, if the issuer later grows EBITDA or reduces interest expense, such that it would be able to incur the previously incurred permitted debt as ratio debt, it may reclassify such debt and thereby increase amounts then available under the permitted indebtedness basket.

Limitation on sale/leasebacks

Sale and leaseback transactions cover any arrangement where an issuer sells property with the intention of leasing it back from the purchaser under a long-term lease. This usually comes with a right to repurchase the asset at the conclusion of the lease.

Indentures generally view this arrangement as a type of secured financing and therefore usually seek to limit the ability of issuers to engage in these transactions, unless they can both incur an amount of debt that is calculated based on the economic terms of the lease (called 'Attributable Debt') and incur the lien in an amount necessary to secure the amount of Attributable Debt.

In addition, the sale component of the sale and leaseback transaction usually has to comply with the asset sale covenant (discussed in Chapter 9) in the first instance.

Example provision 7 shows the typical wording of a limitation on sale and leaseback clause. ♦

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9 Containing and protecting cash and assets – limitations on restricted payments, asset dispositions and dividend stoppers

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Introduction

Among the key features of high-yield indentures are covenants that limit the ability of the issuer and its restricted subsidiaries to use cash and other assets in ways that are detrimental to the creditworthiness of the issuer and the interests of bondholders.

This chapter looks at three covenants:

- Limitation on restricted payments covenant.
- Limitation on asset sales covenant.
- Limitation on restrictions on distributions from restricted subsidiaries covenant.

Collectively, these covenants attempt to prevent cash and other assets from inappropriately leaking out of the system and prohibit the creation of restrictions on an issuer's ability to access cash or other assets within the 'system', thereby preserving value for the benefit of bondholders.

More specifically, these covenants seek to protect bondholders by:

- Limiting payments to equity holders and junior debt holders.
- Limiting the ability of issuers to invest in the debt or equity of third parties.
- Prescribing the type and amount of consideration required from any sale of assets.
- Requiring the proceeds from asset sales to be either reinvested in the issuer's business or used to pay down senior debt (including the high-yield bonds).
- Preserving the free flow of cash within the system to ensure that cash generated by operating subsidiaries can be made available for payments to bondholders.

Limitation on restricted payments covenant

This covenant restricts the amount of cash or other assets that leave the system, including limiting the ability of issuers and their restricted subsidiaries to make payments (such as dividends) for the benefit of equity holders or junior debt holders.

Restricted payments include: the payment of dividends or distributions on equity; repurchases or redemptions of equity (which can be the equivalent of a dividend or distribution); prepayments on junior debt; and the making of 'investments' (broadly defined to include acquisitions of debt and equity and capital contributions as well as any direct or indirect advance, loan, extension of credit or guarantee in favour of a third party).

The restricted payments covenant is one of the most important protections for bondholders and is typically among the most highly negotiated covenants in the high-yield indenture.

From an issuer's perspective, it is critical to ensure that the covenant is drafted with appropriate flexibility to permit it to operate its business without undue burden and to upstream appropriate amounts of cash to private equity sponsors or other equity investors.

The covenant permits the controlled leakage of value out of the system under a 'builder basket', which requires issuers to earn the capacity for making restricted payments by adding value to the system after the issue date. Leakage also occurs through carve-outs for ordinary course of business transactions and negotiated, issuer-specific concerns. These carve-outs are generally available regardless of the issuer's financial health, creditworthiness or ability to use capacity under the builder basket.

Restricted payments covenants typically have three principal components:

1. **A broad prohibition on restricted payments.**
2. **A builder basket.** The builder basket (also commonly referred to as the 'restricted payments basket') permits restricted payments to the extent the issuer has accumulated capacity in the basket since the issue date by adding value to the credit, primarily through accumulated earnings and equity contributions. Restricted payments made out of the basket deplete its capacity, while earnings and equity contributions tend to grow basket capacity over time. The issuer may only make restricted payments out of the basket if it can satisfy conditions testing its financial health and creditworthiness.
3. **Carve-outs.** Various carve-outs from the covenant permit specific restricted payments irrespective of the issuer's financial condition or basket capacity. In addition, most high-yield indentures include a long list of 'permitted investments' covering a broad range of ordinary course of business and negotiated investments can be made without regard to the covenant's restrictions.

These components are discussed in greater detail below.

Types of restricted payments

Most restricted payments fall into one of two general categories:

1. **Transfers to persons who are junior to bondholders in the capital structure.** This category includes the payment of dividends or distributions on equity, repurchases or redemptions of equity and prepayments on junior debt. These payments violate fundamental principles underlying debt finance – namely, that debt should be paid before equity and that senior debt should be paid before junior debt. While the issuer's ability to repay bondholders may be impaired by poor operating results or external shocks, its creditworthiness should not be impaired by transfers of cash or other assets out of the system to pay equity holders or junior creditors.
2. **Investments in third parties.** This category includes acquisitions of debt and equity and capital contributions as well as any direct or indirect advance, loan, extension of

credit or guarantee in favour of a third party. From bondholders' perspective, an issuer should focus on operating its core business and executing the business plan disclosed to bondholders. Bondholders invest in the credit on the basis that cash and other assets, whether existing on the issue date or generated from operations thereafter, will be used to operate the issuer's business, improve the issuer's creditworthiness and pay off the bonds. The covenant prevents the issuer from leaking value by making minority investments and extensions of credit to third parties. By contrast, majority investments that result in the issuer obtaining management control over a new restricted subsidiary involved in its core business are permitted, as are intercompany investments among the restricted subsidiaries and the issuer.

A typical definition of 'restricted payments' is illustrated in Example provision 1.

Example provision 1

Definition of Restricted Payment

'Restricted Payment' with respect to any Person means:

1. the declaration or payment of any dividends or any other distributions of any sort in respect of its Capital Stock (including any payment in connection with any merger or consolidation involving such Person) or similar payment to the direct or indirect holders of its Capital Stock (other than (a) dividends or distributions payable solely in its Capital Stock (other than Disqualified Stock), (b) dividends or distributions payable solely to the Company or a Restricted Subsidiary and (c) pro rata dividends or other distributions made by a Subsidiary that is not a Wholly Owned Subsidiary to holders of a minority stake in the Capital Stock of such Subsidiary);
2. the purchase, redemption or other acquisition or retirement for value of any Capital Stock of the Company held by any Person (other than by a Restricted Subsidiary) or of any Capital Stock of a Restricted Subsidiary held by any Affiliate of the Company (other than by a Restricted Subsidiary), including in connection with any merger or consolidation and including the exercise of any option to exchange any Capital Stock (other than into Capital Stock of the Company that is not Disqualified Stock);
3. the purchase, repurchase, redemption, defeasance or other acquisition or retirement for value, prior to scheduled maturity, scheduled repayment or scheduled sinking fund payment of any Subordinated Obligations of the Company or any Subsidiary Guarantor (other than (a) from the Company or a Restricted Subsidiary or (b) the purchase, repurchase, redemption, defeasance or other acquisition of Subordinated Obligations purchased in anticipation of satisfying a sinking fund obligation, principal instalment or final maturity, in each case due within one year of the date of such purchase, repurchase, redemption, defeasance or other acquisition); or
4. the making of any Investment (other than a Permitted Investment) in any Person.

Investments

Generally, 'investment' is broadly defined to include acquisitions of debt and equity and capital contributions as well as any direct or indirect advance, loan, extension of credit or guarantee in favour of a third party.

The definition often captures all other items that would be classified as investments under applicable accounting rules. The definition also frequently includes language to the effect that the acquisition of a person who holds an investment in another person will be deemed, at the time of the acquisition, to be an investment of the acquirer.

Bondholders generally prefer the definition of 'investment' to be as broad as possible and that any carve-outs be included in the definition of 'permitted investment' rather than narrow the definition of 'investment' itself.

A typical definition of 'investment' is provided in Example provision 2.

Example provision 2

Definition of investment

'Investment' in any Person means any direct or indirect advance, loan (other than advances to customers in the ordinary course of business that are recorded as accounts receivable on the balance sheet of the lender) or other extensions of credit (including by way of Guarantee or similar arrangement) or capital contribution to (by means of any transfer of cash or other property to others or any payment for property or services for the account or use of others), or any purchase or acquisition of Capital Stock, Indebtedness or other similar instruments issued by such Person, together with all items that are or would be classified as investments on a balance sheet prepared in accordance with GAAP. Except as otherwise provided for herein, the amount of an Investment shall be its fair market value at the time the Investment is made and without giving effect to subsequent changes in value. The acquisition by the Company or any Subsidiary of the Company of a Person that holds an Investment in a third person will be deemed to be an Investment by the Company or such Subsidiary in such third Person in an amount equal to the fair market value of the Investment held by the acquired Person in such third Person.

Indentures usually provide that when the issuer designates a subsidiary as an unrestricted subsidiary, the issuer's interest in the fair market value of the net assets of that subsidiary, at the time of designation, will be treated as an investment. Similarly, if the issuer disposes of the capital stock of a restricted subsidiary such that it no longer qualifies as a subsidiary, the resulting minority stake is treated as a new investment.

The builder basket

The builder basket is designed to permit restricted payments in proportion to the issuer's credit improvement since the issue date. Conceptually, the basket reflects the willingness of bondholders to allow some value to leak out of the system, provided that:

1. The value was created after the issue date.
2. A large portion of the value created benefits bondholders by remaining in the system.
3. The issuer is financially healthy.

Building the basket

Typically, the restricted payments covenant gives issuers credit for the following types of value contributed to the system after the issue date:

- Consolidated net income.
- The net proceeds from sales of qualified equity (that is, equity that does not have any of the attributes of debt).
- The principal amount of pari passu or senior debt converted or exchanged into qualified equity.
- Net proceeds received from the sale of any investment that was made after the issue date.
- The value of any unrestricted subsidiary redesignated as a restricted subsidiary.

In return for allowing some value to leak out of the system, bondholders require a portion of the value created after the issue date to stay in the system. Typically, bondholders and equity holders divide accumulated net earnings 50/50. This usually means that fifty percent of the issuer's consolidated net income since the issue date is made available for restricted payments under the builder basket. The balance is required to stay in the system to enhance the credit.

For all other types of value added to the system after the issue date (including equity proceeds, conversions or exchanges of debt for qualified equity, sales of investments and the redesignation of unrestricted subsidiaries), the issuer gets full credit and is able to make restricted payments under the builder basket on a dollar-for-dollar basis.

Basket mechanics can vary, particularly when an issuer is not expected to go earnings positive for an extended period after issuance, in private equity sponsor-led deals (where the sponsor expects enhanced access to issuer dividends) and in deals from 'crossover credits' at the cusp of an investment-grade rating. For instance, some indentures give credit for consolidated net income accrued prior to the issue date of the bonds. Some indentures provide a 'head start' dollar amount that is deemed to be included in the basket upon issuance. Some baskets build based on a leverage ratio or an excess cash-flow concept, and in some sponsor deals there is no cap on the amount of restricted payments that may be made if a specified leverage ratio is satisfied.

Conditions for using the basket

Even if an issuer has accumulated capacity available for restricted payments in the builder basket, the restricted payments covenant usually requires the issuer to satisfy two additional conditions before allowing value to leak out of the system:

1. There can be no default under the indenture.
2. The issuer must be able to incur US$1.00 of additional debt pursuant to the debt incurrence covenant.

In effect, these conditions impose an additional credit check on the issuer at the time of any restricted payment made out of the basket. Issuers that are too highly levered, performing poorly, struggling financially or are otherwise unable to satisfy their obligations under the indenture are required to retain accumulated value for the benefit of bondholders rather than allow it to leak out of the system.

Example provision 3 below illustrates a builder basket construct.

Example provision 3

Restricted payments builder basket

The Issuer shall not, and shall not permit any of its Restricted Subsidiaries, directly or indirectly, to make any Restricted Payment, if at the time the Issuer or such Restricted Subsidiary makes such Restricted Payment:...

the aggregate amount of such Restricted Payment and all other Restricted Payments made subsequent to the Issue Date would exceed the sum (without duplication) of:

A. 50% of Consolidated Net Income for the period (treated as one accounting period) from the first day of the first fiscal quarter following the Issue Date to the end of the most recent fiscal quarter ending prior to the date of such Restricted Payment for which financial statements of the Issuer are available (or, in the case such Consolidated Net Income is a deficit, minus 100% of such deficit);
B. 100% of the aggregate Net Cash Proceeds received by the Issuer from the issue or sale of its Capital Stock (other than Disqualified Stock or Designated Preferred Stock) subsequent to the Issue Date or otherwise contributed to the equity (other than through the issuance of Disqualified Stock or Designated Preferred Stock) of the Issuer subsequent to the Issue Date (other than (x) Net Cash Proceeds or property or assets or marketable securities received from an issuance or sale of such Capital Stock to a Restricted Subsidiary or an employee stock ownership plan or trust established by the Issuer or any Subsidiary of the Issuer for the benefit of its employees to the extent funded by the Issuer or any Restricted Subsidiary, (y) Net Cash Proceeds to the extent such Net Cash Proceeds have been used to Incur Indebtedness pursuant to Contribution Debt basket and (z) Excluded Contributions);
C. 100% of the aggregate Net Cash Proceeds received by the Issuer or any Restricted Subsidiary from the issuance or sale (other than to the Issuer or a Restricted Subsidiary of the Issuer or an employee stock ownership plan or trust established by the Issuer or any Subsidiary of the Issuer) by the Issuer or any Restricted Subsidiary subsequent to the Issue Date of any Indebtedness, Disqualified Stock or Designated Preferred Stock that has been converted into or exchanged for Capital Stock of the Issuer (other than Disqualified Stock or Designated Preferred Stock) plus, without duplication, the amount of any cash

received by the Issuer or any Restricted Subsidiary upon such conversion or exchange; and

D. in the case of the redesignation of an Unrestricted Subsidiary as a Restricted Subsidiary, the amount of the Investment in such Unrestricted Subsidiary made by the Issuer or a Restricted Subsidiary or to the extent of the amount of the Investment that constituted a Permitted Investment.

Carve-outs and baskets

Many highly leveraged issuers will, at some point during the life of their bonds, lack capacity in the builder basket to make restricted payments or fail to satisfy the conditions for using accumulated capacity in the builder basket. In recognition of the impracticality of relying solely on the builder basket, the restricted payments covenant typically permits restricted payments to be made under a series of carve-outs and baskets, many of which are highly negotiated and specifically tailored to the issuer's business plans, prospects and financial circumstances.

The scope and liberality of these carve-outs are influenced by the negotiating leverage of the issuer and its private equity sponsors as well as market conditions at the time of the offering. These exceptions are typically divided between carve-outs in the restricted payments covenant itself and carve-outs and baskets that fall within the definition of 'permitted investments'.

For each carve-out from the covenant, a determination needs to be made whether restricted payments made pursuant to that carve-out count against the builder basket and whether the carve-out will remain available if the issuer is in default under the indenture.

Carve-outs from the restricted payments covenant frequently include the following items:

- **Payment of declared dividends that were permitted at the time of declaration.** In many jurisdictions, once a dividend is declared, it becomes a liability of the issuer and must, by law, be paid. Issuers are typically required to declare dividends and set record dates in advance of actually paying dividends. This carve-out addresses a practical problem, which can result if an issuer has capacity to pay a dividend on the date of declaration but, due to changed circumstances, is unable to pay the dividend under the indenture on the date set for payment. This is not so much a carve-out as a rule of construction, which provides that the ability to pay dividends will be measured at the time of declaration rather than at the time of payment.
- **Concurrent issuances and repurchases of equity or junior debt.** This carve-out permits the repurchase or redemption of equity or junior debt with the proceeds of contemporaneous issuances of equity or junior debt. Bondholders should be indifferent to what is basically a refinancing below them in the capital structure. Double-counting is expressly prohibited; the proceeds of the new equity used to redeem existing equity cannot also be used to top up the builder basket. Some deals permit any type of

restricted payment (not only the repurchase or redemption of equity or junior debt) to be made in reliance on this carve-out.

- **Corporate overhead and taxes.** To the extent that corporate, legal, treasury and other management functions occur at a holding company level above the issuer, certain expenses legitimately incurred on the issuer's behalf in the ordinary course of business are viewed as appropriately reimbursable and carved out of the restricted payments covenant (often subject to a cap).
- **Repurchases of equity from employees.** This carve-out permits the repurchase of equity upon the termination of an employee, director or consultant or otherwise according to an employee benefit plan. The carve-out is usually subject to an annual cap (with unused amounts frequently available for carryover).
- **Post-IPO dividends.** For issuers that plan to go public during the life of the bonds, issuers typically negotiate a carve-out that permits the payment of dividends after the IPO. Dividends subject to this carve-out are usually capped at six percent of the net proceeds from any equity sale after the issue date or, in some sponsor-led deals, six percent of market cap.
- **Cashless exercises.** There is often a carve-out for cashless exercises of options, warrants or similar instruments (that is, the deemed repurchase of equity upon the exercise of the option, warrant or similar instrument, where a portion of the equity is used in satisfaction of the exercise price).
- **Excluded contributions.** Many deals include an 'excluded contributions' basket, which is essentially a second builder basket that grows exclusively from designated equity contributions. The primary advantage of inserting equity into the excluded contributions basket instead of the builder basket is that restricted payments made out of the excluded contributions basket are not subject to the 'no default' or 'US$1.00 of debt test' conditions that apply to the builder basket.
- **General basket.** The restricted payments covenant typically includes a general basket for the payment of any restricted payments, subject to a dollar cap.

Permitted investments

All investments are restricted payments unless they qualify as 'permitted investments'. Typically, this includes:

- Investments within the restricted group (that is, the issuer and its restricted subsidiaries).
- Investments in cash and cash equivalents.
- Certain ordinary course of business investments.
- Certain other investments that are customarily carved out from the restrictions on investments.
- A general basket for an aggregate amount not exceeding a certain threshold.

From a bondholders' perspective, a decision to permit a particular type of investment largely hinges on the issuer's ability to control the flow of funds from the entity in which it or a restricted subsidiary has invested. For that reason, an investment in the issuer or a restricted subsidiary is almost always permitted because the money invested stays within the 'system' (that is, the restricted group).

Investments in cash and highly liquid, short-term investment-grade cash equivalents are always permitted as these are cash generating, relatively safe investments, regarding which the issuer has a high degree of control over the flow of funds.

Included in the ordinary course of business types of permitted investments are, among others:

- Payroll, travel and other advances made in the ordinary course of business, which are treated as expenses for accounting purposes.
- Loans or advances to employees.
- Stock, obligations or securities received in settlement of debts created in the ordinary course of business and owing to the issuer or any restricted subsidiaries.

Also falling within the definition of permitted investments are provisions designed to allow issuers to engage in certain activities permitted under certain other covenants in the indenture without inadvertently breaching the restricted payment covenant. For example, allowing issuers to accept non-cash consideration, which is permitted under the asset sales covenant, and allowing any investment that consists of hedging obligations, which is permitted under the indebtedness covenant.

Finally, issuers may request other types of permitted investments based on its business activities and foreseeable needs. Common examples include:

- Baskets for investments in joint venture or similar arrangements.
- Baskets for unrestricted subsidiaries where such investments are otherwise not generally permitted.
- Investments in receivable subsidiaries or similar securitisation vehicles.

Limitation on asset sales covenant

The limitation on asset sales covenant seeks to protect bondholders by specifying the terms on which issuers may sell assets and circumscribing the use of proceeds received therefrom.

Bondholders' general expectations are that proceeds from the sale of assets be reinvested in the issuer's business or, failing that, used to de-lever the issuer, including through an offer to repurchase the bonds. [For a typical limitation on asset sales clause, see Example provision 4.]

Importantly, the typical high-yield indenture does not prohibit issuers from selling assets and neither does it impose a cap on the amount of assets that may be sold, subject to standard restrictions on sales of substantially all of the assets of the issuer. On the contrary, the covenant usually permits issuers to freely sell assets, even extremely valuable or critical assets, subject only to limitations on the consideration received and the issuer's use of proceeds.

Accordingly, the typical asset sales covenant is structured to require that issuers receive fair market value and primarily cash consideration for any assets sold. Furthermore, following the sale of any material assets, issuers are required (within a specified period of time) to use the proceeds to repay senior debt, to reinvest in the business or offer to repurchase the bonds.

Asset sales/ dispositions

The scope of the asset sales covenant is limited to those sales of assets that constitute an 'asset sale' or 'asset disposition' as defined in the indenture. While attention must be paid to transactions that a particular issuer undertakes on a regular basis or in the ordinary course of its business to ensure that the asset sales covenant does not unintentionally limit the issuer from conducting its business, the definition of asset sale does not vary as much as many of the other definitions found in high-yield covenant packages.

Example provision 4

Asset sales covenant

The Issuer shall not, and shall not permit any Restricted Subsidiary to, directly or indirectly, consummate any Asset Sale unless:

1. the Issuer or such Restricted Subsidiary receives consideration at the time of such Asset Sale at least equal to the fair market value, as determined in good faith by the Board, of the assets subject to such Asset Sale;
2. at least 80% of the consideration received by the Issuer or such Restricted Subsidiary is in the form of cash or cash equivalents;
3. an amount equal to 100% of the net proceeds from such Asset Sale is applied by the Issuer (or such Restricted Subsidiary, as the case may be)

   A. first, to the extent the Issuer elects (or is required by the terms of any Indebtedness), to prepay, repay, redeem or purchase Secured Indebtedness or Indebtedness of a non-guarantor Restricted Subsidiary (in each case, other than intercompany Indebtedness) within one year from the later of the date of such Asset Sale or the receipt of such net proceeds;
   B. second, to the extent of the balance of such Net Available Cash after application in accordance with clause (A), to the extent the Issuer elects, to acquire non-current assets or the Capital Stock of a Person that becomes a Restricted Subsidiary (in each case engaged in a Related Business) within one year from the later of the date of such Asset Sale or the receipt of such net proceeds; and
   C. third, to the extent of the balance of such net proceeds after application in accordance with clauses (A) and (B), to make an offer to the holders of the notes (and to holders of other pari passu Indebtedness) to purchase notes (and such other pari passu Indebtedness); provided, however, that in connection with any prepayment, repayment or purchase of Indebtedness pursuant to clause (A) or (C) above, the Issuer or such Restricted Subsidiary shall permanently retire such Indebtedness and shall cause the related loan commitment (if any) to be permanently reduced in an amount equal to the principal amount so prepaid, repaid or purchased.

Notwithstanding the foregoing provisions, the Issuer and the Restricted Subsidiaries shall not be required to apply the net proceeds of an Asset Sale in accordance with this Section except to the extent that the aggregate net proceeds from all Asset Sales that are not applied in accordance with this Section exceeds US$[XX] million.

Pending application of net proceeds of Asset Sales pursuant to this Section, such net proceeds shall be invested in cash equivalents or applied to temporarily reduce revolving credit indebtedness.

Generally, issuers negotiate as high a 'hurdle' as possible in terms of a dollar value below which sales or dispositions do not trigger the covenant, as well as a number of customary carve-outs for ordinary course of business transactions and sales of all, or substantially all, of the issuer's assets, which is covered by the merger covenant discussed in Chapter 10.

The following are examples of excluded transactions not classed as asset dispositions for the purposes of the covenant:

- Assets with a fair market value less than US$500,000.
- Transfers by a restricted subsidiary to an issuer or by an issuer or restricted subsidiary to a restricted subsidiary (which in some indentures must be a wholly-owned subsidiary).
- Asset dispositions that constitute a restricted payment and that are not prohibited by the limitation of restricted payments covenant.
- The sale of products, services and current assets in the ordinary course of business including, in some indentures, the disposal of obsolete assets.
- Cash or temporary cash investments.
- Creation of a lien (which is otherwise permitted by the indenture).

Cash consideration

At least a certain percentage of the consideration received from an asset disposition should be in cash or cash equivalents, which is designed to ensure that issuers have cash available to repay debt or to invest in new assets as required under the asset sales covenant.

Indentures often include a 'deemed cash' provision, which allows issuers to include as cash certain other forms of consideration received in the asset disposition, including, but not limited to, equity securities in an entity engaged in a permitted business that becomes a restricted subsidiary and securities that are readily exchangeable for cash and are so exchanged within a certain time period.

Use of proceeds

The limitation on asset sales in an indenture typically requires issuers to invest the proceeds from the asset sale in a permitted business within a certain time period, commonly 365 days.

Typical uses include the purchase of non-current assets and the purchase of equity securities in an entity that is engaged in a permitted business and that becomes a restricted subsidiary (which is also why such equity securities are treated as cash equivalents for the purposes of the covenant). Failure to use the proceeds within the proscribed time period will mean that an issuer is required to use the proceeds to de-lever the issuer. This is typically done through the permanent repayment of *pari passu* indebtedness (that is, the revolving indebtedness repayment must involve the reduction of the related commitment) or by conducting an asset sale offer.

In practice, an asset sale offer is rarely made as issuers are often required to repay debt under their credit facilities with asset sale proceeds or to put the proceeds to use by investing in the issuer's business.

Asset sale offer

Where a tender offer is to be made for the bonds, indentures typically allow issuers to defer launching the offer until a sufficiently large amount of proceeds has accumulated (typically at least US$5 million to US$10 million, depending on the size of the original offering).

In addition, indentures typically set out in detail, either under the asset sale covenant or the section dealing with redemption and prepayment, the mechanics of a tender for the bonds with the excess proceeds from asset dispositions.

Finally, to ensure the integrity of any tender offer process and to allow all bondholders to participate in the tender offer, indentures often require issuers to comply with the tender offer rules under the US securities law and other applicable securities laws or regulations. This means that the tender offer rules in Section 14(e) and Rule 14e-1 under the Securities Exchange Act 1934, as amended, apply, which require, among other things, that all tender offers be kept open for a minimum of 20 business days from commencement and 10 business days from notice of a change in the percentage of securities sought, consideration offered or a dealer's soliciting fee (see Chapter 11 for a discussion of debt tender offers).

Limitation on 'Dividend Stoppers' covenant

The limitation on dividends and other payment restrictions affecting restricted subsidiaries covenant (generally referred to as the 'limitation on dividend stopper' covenant) seeks to protect bondholders not by limiting the leakage of value outside of the system, but by ensuring that value within the system can be used for the payment of interest under the bonds.

The limitation on dividend stoppers covenant is designed to ensure that issuers have access to cash generated by its operating subsidiaries, which, of course, is particularly important if the issuer is a holding company with no independent assets or operations and is reliant on the cash-flow generated by its subsidiaries to support its credit obligations, including for payment of interest under the bonds.

This covenant is also one of the most overlooked and can be a trap for the unwary, particularly for issuers that undertake significant business through controlled joint ventures or international subsidiaries that often have their own working capital facilities and other liquidity sources.

The limitation on dividend stoppers covenant prohibits the issuer's restricted subsidiaries from entering into agreements that limit their ability to pay dividends (for example, restricted payments covenants), provide intercompany loans (such as restrictions on investments in and transactions with affiliates) or transfer assets to the issuer or other restricted subsidiaries. Accordingly, the covenant is intended to prohibit dividend blockers in debt instruments or other agreements at the subsidiary level that would constrain their ability to upstream cash or other assets to issuers and subsidiary guarantors.

As with many of the other covenants, the key to the dividend stopper covenant is to ensure that the exceptions adequately protect bondholders, but that they do not unduly limit the issuer from conducting its business as it has historically operated and is expected to operate in the future. For example, typical exceptions include: credit and other debt agreements of subsidiaries, to the extent the subsidiary is permitted to incur such debt; agreements existing on the issue date; merger or similar acquisition or disposition; agreements, leases, licenses, legal encumbrances permitted to be incurred; hedging obligations; securitisations; limitations in joint venture agreements (broader exceptions if joint ventures are important to the business); and, importantly, amendments, restatements and replacements of the foregoing agreements. ♦

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10 Game changers and self-dealing – limitations on mergers, change of control and affiliate transactions

By Arnie Peinado, Deborah Conrad, Ben Miles and York Wu,
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Introduction

The typical high-yield bondholder tends to make its decision to invest in a particular series of bonds based, in part, on certain core facts relating to the issuer, such as its legal existence and ownership structure. Bondholders expect these core facts to remain a constant until maturity or to have protection against a significant change in these core facts.

Accordingly, the high-yield covenant package has evolved to provide bondholders' protection against 'game-changing' events, which generally consist of:

- A covenant restricting issuers and the guarantors from undertaking certain transactions that would fundamentally change their legal existence or character.
- A covenant providing that if an issuer undergoes a change of control, then it is required to offer to purchase its bonds at a price equal to 101 percent of their par value, which gives bondholders the right (but not the obligation) to exit their investment with a slight premium to offset a portion of the lost interest expense the bond would otherwise have provided over time.

In addition, high-yield bondholders also want to be protected from issuers engaging in transactions with (and thereby leaking value to) affiliates, even if the particular transaction does not constitute a restricted payment. Consequently, the high-yield covenant package has developed to provide bondholders with protection in the form of an affiliate transactions covenant, which is also discussed below.

Merger covenant

High-yield bond indentures, like investment-grade indentures, include a covenant restricting issuers and any guarantors from merging with other entities, or selling or transferring all, or substantially all, of their assets to another entity unless the buyer assumes all of the obligations under the indenture.

A common formulation of this covenant – often referred to as the merger covenant or the fundamental change covenant – is provided in Example provision 1.

Typically, any such merger, sale or transfer is only permitted if:

- The entity into which the issuer or guarantor is merged (or to which their assets are sold or transferred) assumes the issuer's or the guarantor's obligations under the indenture.
- The successor entity is organised in a specified permitted jurisdiction.

- Legal opinions and/or officers' certificates relating to the transaction are delivered to the trustee.
- There is no default or event of default under the indenture.

Often, issuers must also be able to incur an additional dollar of debt under the fixed charge coverage ratio (or leverage ratio) incurrence test set out in the debt covenant – after giving pro forma effect to the proposed transaction – in order for any such merger or sale to be permitted.

The merger covenant is critical for bondholders because it prevents the obligors on the bonds from fundamentally altering their legal characteristics, which bondholders relied on at the time of making their investment. In addition, the covenant restricts transactions that might have the effect of undermining the legal nature of the obligations owing to bondholders.

Although the merger covenant offers crucial protections for bondholders, it is generally not as heavily negotiated as other covenants (such as the debt covenant and restricted payments covenant) in the high-yield covenant package. This is because issuers, as a general matter, accept the premise that they should not be able to fundamentally alter their legal identity and the legal nature of the obligations owing to bondholders.

Example provision 1

Merger covenant

The Issuer shall not consolidate with or merge with or into, or convey, transfer or lease, in one transaction or a series of transactions, all or substantially all its assets to, any Person, unless:

1. the resulting, surviving or transferee Person (the 'Successor Company') shall be a Person organised and existing under the laws of the United States of America, any State thereof or the District of Columbia and the Successor Company (if not the Issuer) shall expressly assume, by an indenture supplemental thereto, executed and delivered to the Trustee, in form satisfactory to the Trustee, all the obligations of the Issuer under the Securities and the Indenture; provided, that if the Successor Company is not a corporation, a corporate Wholly Owned Subsidiary that is a Restricted Subsidiary organised under the laws of the United States of America, any State thereof or the District of Columbia becomes a co-issuer of the Securities;
2. immediately after giving effect to such transaction (and treating any Indebtedness which becomes an obligation of the Successor Company or any Subsidiary as a result of such transaction as having been Incurred by such Successor Company or such Subsidiary at the time of such transaction), no Default shall have occurred and be continuing;
3. immediately after giving effect to such transaction, the Successor Company would be able to Incur an additional $1.00 of ratio Indebtedness;
4. the Issuer shall have delivered to the Trustee an Officers' Certificate and an Opinion of Counsel, each stating that such consolidation, merger or transfer and such supplemental indenture (if any) comply with the Indenture.

Change of control transactions

While the merger covenant provides bondholders with certain structural protections, there are structural changes that an issuer may undergo that are not addressed by the merger covenant and against which bondholders often seek protection, most significantly, a change of control.

High-yield indentures generally assume that bondholders consider the identity of the issuer's controlling shareholder or, if applicable, the absence of a controlling shareholder, as an important investment criteria. As a result, in the event of the occurrence of a change of control (as defined) with respect to an issuer, nearly all high-yield indentures require issuers to offer to purchase all of the outstanding bonds at a price equal to 101 percent of their principal amount and purchase all bonds that are tendered in response to the offer to purchase.

This feature (often referred to informally as the 'change of control put right') reflects a theme visible throughout high-yield bond indentures of trying to find a balance between investor protection and flexibility for the issuer. Rather than impose an absolute prohibition on a change of control, which might give bondholders undue leverage, the high-yield bond indenture permits a change of control transaction provided the 101 percent offer is made.

If, following the announcement of the change of control transaction, an issuer's bonds trade above 101 percent of their par value (or continue to trade above 101 percent of par), bondholders may very well not accept that offer and choose to continue to either sell their position for a higher price or hold their position. In either case, bondholders are afforded the opportunity to reassess the new controlling shareholder and the credit quality of their investment and to exit at a slight premium.

Example provision 2

Definitions of Change of Control and Permitted Holders

'Change of Control' means the occurrence of any one of the following:

1. any 'person' (as such term is used in Sections 13(d) and 14(d) of the Exchange Act), other than one or more Permitted Holders, is or becomes the 'beneficial owner' (as defined in Rules 13d-3 and 13d-5 under the Exchange Act), except that any person other than a Permitted Holder shall be deemed to have 'beneficial ownership' of all shares that any such person has the right to acquire, whether such right is exercisable immediately or only after the passage of time), directly or indirectly, of more than 50% of the total voting power of the Voting Stock of the Issuer;
2. individuals who on the Issue Date constituted the Board (together with any new directors whose election by such Board or whose nomination for election by the shareholders of the Issuer was approved by a vote of a majority of the directors of the Issuer then still in office who were either directors on the Issue Date or whose election or nomination for election was previously so approved or who were elected with the consent of the Permitted Holders) cease for any reason to constitute a majority of the Board of Directors then in office;

3. the adoption of a plan relating to the liquidation or dissolution of the Issuer; or
4. the merger or consolidation of the Issuer with or into another Person or the merger of another Person with or into the Issuer, or the sale of all or substantially all the assets of the Issuer (determined on a consolidated basis) to another Person other than (i) a transaction in which the survivor or transferee is a Person that is controlled by Permitted Holders or (ii) a transaction following which (A) in the case of a merger or consolidation transaction, holders of securities that represented 100% of the Voting Stock of the Issuer immediately prior to such transaction (or other securities into which such securities are converted as part of such merger or consolidation transaction) own directly or indirectly at least a majority of the voting power of the Voting Stock of the surviving Person in such merger or consolidation transaction immediately after such transaction and in substantially the same proportion as before the transaction and (B) in the case of a sale of assets transaction, each transferee becomes an obligor in respect of the Notes and a Subsidiary of the transferor of such assets.

'**Permitted Holders**' means the Private Equity Sponsor who holds Equity Interests of the Issuer (or any of its direct or indirect parent companies) and any group (within the meaning of Section 13(d)(3) or Section 14(d)(2) of the Exchange Act or any successor provision) of which the Private Equity Sponsor is a member; provided that, in the case of such group and without giving effect to the existence of such group or any other group, such Private Equity Sponsor has beneficial ownership of more than 50% of the total voting power of the Voting Stock of the Issuer or any of its direct or indirect parent companies.

There are several provisions in a high-yield bond indenture relating to the change of control put right, but most of them are not heavily negotiated. Much of what is included in the indenture on this provision relates to the timing and mechanics of making the offer to purchase and to the process for accepting bonds tendered in response to the offer. The definition of what constitutes a change of control and what triggers the requirement to make the offer to purchase, on the other hand, is another provision that both varies in fairly significant ways across issuers and receives a lot of attention from bondholders and issuers alike. Example provision 2 provides a common definition of 'Change of Control' and illustrates the key elements negotiated.

Almost as important to the definition of change of control is the definition of 'Permitted Holder', which is also shown in Example provision 2.

A change of control always includes, but is generally not limited to, a change in the controlling shareholder of the issuer. This is typically the core component and is usually triggered if any person or group acquires 50 percent or more of the voting stock of the issuer, as illustrated in clause (1) of the definition of Change of Control in Example provision 2. It is generally not intended to trigger in a situation where the voting stock of the issuer comes to rest in the hands of a diverse shareholder base (in the case of an IPO), but seeks to capture the scenario in which a new controlling shareholder gains control of the business.

A change of control event also generally includes a trigger for the sale of all, or substantially all, of an issuer's assets and its subsidiaries to another person. The indenture generally does not elaborate or provide specific criteria as to what constitutes 'all or substantially all' assets. Instead, any determination will be fact-specific requiring individual analysis on a case-by-case basis in light of applicable case law. There is usually disclosure in high-yield offering documents highlighting for prospective bondholders the ambiguity of the phrase 'all or substantially all'.

Although not included in every transaction, other triggers include prongs for director turnover in connection with proxy fights (also called a 'continuing director' provision) and as a result of the adoption of a plan of liquidation or dissolution. Issuers need to be cognizant of the implications of continuing director provisions with respect to shareholder voting rights, particularly if the issuer is a public company or is considering going public.

Affiliate transactions covenant

As a general principle, the high-yield covenant package does not restrict an issuer or its subsidiaries from entering into ordinary course of business contracts or transactions unless one of the covenants is specifically implicated (for example, if a transaction contract involves the incurrence of new debt or liens). The covenant representing a key exception to this principle is the affiliate transactions covenant (see Example provision 3).

The affiliate transactions covenant generally restricts the issuer from entering into any transaction (in excess of a specified materiality threshold) with any affiliate (generally defined as an entity controlling, controlled by or under common control with the issuer) irrespective of the purpose or nature of the transaction, unless:

- The transaction is on terms that are arm's length.
- If the transaction is in excess of a specified materiality threshold, the transaction is certified as being on arm's-length terms by a board resolution.
- If the contract or transaction is in excess of an even higher specified materiality threshold, the transaction is certified as being on arm's-length terms by an opinion of an accounting, appraisal or investment banking firm of national standing.

The rationale for the covenant is fairly simple – there is reason to view with a cautious eye any transaction in which an issuer is dealing with an affiliate.

Specifically, the concern is that an affiliate transaction could really be a restricted payment in another form (that is, that the issuer could use payments pursuant to a contract as a way of bleeding value outside the restricted group in favour of junior claimants and at the expense of bondholders) in lieu of a traditional dividend. Accordingly, the guiding principle of the affiliate transactions covenant is to permit these transactions, provided there is support for the notion that they are fair to the issuer and not in fact dividends in disguise (as noted above, with the burden of proof increasing as the materiality of the transactions increase).

Example provision 3

Affiliate transactions covenant

The Issuer shall not, and shall not permit any of its Restricted Subsidiaries to, make any payment to or sell, lease, transfer or otherwise dispose of any of its properties or assets to, or purchase any property or assets from, or enter into or make or amend any transaction, contract, agreement, understanding, loan, advance or guarantee with, or for the benefit of, any Affiliate of the Issuer (each, an 'Affiliate Transaction') involving aggregate payments or consideration in excess of US$[XX], unless:

1. the Affiliate Transaction is on terms that are no less favourable to the Issuer or the relevant Restricted Subsidiary than those that would have been obtained in a comparable transaction by the Issuer or such Restricted Subsidiary with an unrelated Person; and
2. the Issuer delivers to the trustee:
   a. with respect to any Affiliate Transaction or series of related Affiliate Transactions involving aggregate consideration in excess of US$[XX], a resolution of the Board of Directors of the Issuer set forth in an officers' certificate certifying that such Affiliate Transaction complies with this covenant and that such Affiliate Transaction has been approved by a majority of the disinterested members of the Board of Directors of the Issuer; and
3. with respect to any Affiliate Transaction or series of related Affiliate Transactions involving aggregate consideration in excess of US$[XX], an opinion as to the fairness to the Issuer or such Restricted Subsidiary of such Affiliate Transaction from a financial or valuation point of view issued by an accounting, appraisal or investment banking firm of national standing.

It is important to note however that the typical affiliate transactions covenant permits a specified list of transaction types (such as those reflected in Example provision 4), irrespective of whether they are on an arm's-length basis, these are generally negotiated by the issuer and the underwriters in light of the issuer's existing contractual arrangements and past practice. ♦

Example provision 4

Exceptions to affiliate transactions covenant

The following transactions will not be deemed to be Affiliate Transactions and will not be subject to the provisions of the prior paragraph:

1. any employment agreement, employee benefit plan, officer or director indemnification agreement or any similar arrangement entered into by the Issuer or any of its Restricted Subsidiaries in the ordinary course of business and payments pursuant thereto;
2. transactions between or among the Issuer and/or its Restricted Subsidiaries;
3. transactions with a Person (other than an Unrestricted Subsidiary of the Issuer) that is an Affiliate of the Issuer solely because the Issuer owns, directly or through a Restricted Subsidiary, an Equity Interest in, or controls, such Person;
4. payment of reasonable and customary fees and reimbursements of expenses (pursuant to indemnity arrangements or otherwise) of officers, directors, employees or consultants of the Issuer or any of its Restricted Subsidiaries;
5. any issuance of Equity Interests (other than Disqualified Stock) of the Issuer to Affiliates of the Issuer;
6. Restricted Payments that do not violate the provisions of the indenture described above under the caption 'Certain Covenants—Limitation on Restricted Payments'; and
7. loans or advances to employees in the ordinary course of business not to exceed US$[XX] in the aggregate at any one time outstanding.

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11

Paying off high-yield bonds – redemptions, tender offers, defeasance and satisfaction and discharge

By Stuart Morrissy, Brett Nadritch, April Heidt and James McFarlane, Milbank Tweed Hadley & McCloy LLP

Introduction

It should not come as a surprise that very few high-yield bond issuances are repaid at maturity. Rather, most are repaid well before their maturity date. What might be surprising is the wide range of options that issuers have to choose from when repaying their outstanding bonds. The option that is most focused upon (and one of the most important terms of any issuance of high-yield bonds) is optional redemption, or 'call' rights, that the issuer has under the express terms of the indenture to pay off the bonds prior to maturity. Other options include repurchasing outstanding bonds in tender offers, exchanging outstanding bonds for new securities and discharging or defeasing outstanding bonds utilising a customary twist on redemption rights.

Redemption or call rights

Redemption features can either be mandatory or optional. It is very rare for high-yield bonds to have mandatory redemption provisions requiring an issuer to prepay the outstanding bonds prior to maturity. However, occasionally bonds will have economic terms that are similar to amortisation payments in credit agreements and these terms are typically reflected as a mandatory redemption for a predetermined portion of the outstanding bonds (for example, 5 percent of the original principal amount of the series on every interest payment date).

While mandatory redemption provisions are rare, optional redemption provisions, which give the issuer the right to redeem (or call) the outstanding bonds, are very typical of high-yield bonds and are among the most highly negotiated of economic terms.

Non-call periods and declining premium redemptions

Investment-grade bonds are often 'non-call' for life, meaning that issuers do not have the contractual right to prepay the outstanding bonds prior to their maturity.[1] High-yield bonds, on the other hand, usually have a number of optional call rights. The most common is the right to redeem the bonds beginning half way through their tenor (called the first call date) at a premium that typically begins at 50 percent of the stated coupon rate (for example, a 10 percent coupon would result in a 5 percent premium over par) and then declines ratably to par in the last year or two of the bonds' tenor, depending on the length of the original tenor.

[1] In the past several years, some investment-grade issuances have included the right of the issuer to redeem the bonds at par in the last three or six months prior to maturity, depending on the original tenor of the bond, but this feature is not typical of all investment-grade notes and is often rejected by investors.

Recently, certain issuers have been able to improve this call feature by one year, but at a premium that begins at 75 percent of the bonds' coupon. The bond vernacular for these types of bonds is stated as 'non-call x year bonds' where x equals the number of years prior to the first call date. We expect that these call features will change over time depending on market conditions and demand for the issuer's bonds. Example provision 1 illustrates this optional redemption structure.

Example provision 1

Declining premium call feature

On and after [date] the Issuer may redeem the notes, in whole or in part, upon not less than 30 nor more than 60 days' prior notice mailed by first-class mail to the registered address of each holder of notes or otherwise in accordance with the procedures of The Depository Trust Corporation, at the redemption prices (expressed as percentages of principal amount of the notes to be redeemed) set forth below, plus accrued and unpaid interest thereon, if any, to the applicable redemption date, subject to the right of holders of notes of record on the relevant record date to receive interest due on the relevant interest payment date, if redeemed during the twelve-month period beginning on [XX] of each of the years indicated below:

Year	Premium
20XX	100.xxx%
20XY	100.yyy%
20XZ	100.00%

Make-whole redemptions

Another common call feature gives issuers the right to redeem bonds prior to the date when the above-described call features are available at a redemption price determined based on a 'make-whole' discounted net present value of interest and principal payments to the first call date, including the premium applicable on the first call date.

The discount rate is keyed off of the yield on a series of US Treasury securities that mature as close as possible to the first call date, typically plus an additional 50 basis points (referred to as T+50 make-whole call feature). This redemption construct is illustrated in Example provision 2.

Example provision 2

Make-whole redemption

At any time prior to [date] the Issuer may on any one or more occasions redeem all or a part of the notes, upon not less than 30 nor more than 60 days' notice, at a redemption price equal to 100% of the principal amount of the notes redeemed, plus the Applicable

Premium as of, and accrued and unpaid interest, if any, to the date of redemption, subject to the rights of holders of notes on the relevant record date to receive interest due on the relevant interest payment date.

'**Applicable Premium**' means, with respect to any note on any redemption date, the greater of (1) 1.0% of the principal amount of the note; and (2) the excess of (a) the present value at such redemption date of the redemption price of the note at [date], plus all required interest payments due on the note through [date] (excluding accrued but unpaid interest to the redemption date), computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points, over the principal amount of the note.

'**Treasury Rate**' means, as of any redemption date, the yield to maturity as of such redemption date of United States Treasury securities with a constant maturity (as compiled and published in the most recent Federal Reserve Statistical Release H.15 (519) that has become publicly available at least two business days prior to the redemption date (or, if such Statistical Release is no longer published, any publicly available source of similar market data)) most nearly equal to the period from the redemption date to [date] provided, however, that if the period from the redemption date to [date] is less than one year, the weekly average yield on actually traded United States Treasury securities adjusted to a constant maturity of one year will be used.

Equity clawbacks

The final customary call feature in high-yield bonds gives issuers the right to use proceeds from equity offerings to redeem a portion of the outstanding bonds. This is referred to as an 'equity clawback' redemption feature.

Originally, this feature was limited to proceeds from an initial public offering (IPO) of an issuer, which allowed issuers to deleverage to levels more typical of public companies with the IPO proceeds. Customarily, this feature allowed for 35 percent of the outstanding bonds to be redeemed with IPO proceeds so long as 65 percent of the original amount of bonds issued remained outstanding after the redemption.

Like other call features, certain issuers have been able to negotiate more favourable terms, including being able to: use proceeds from any equity offering (not only IPOs); redeem up to 40 percent of the outstanding bonds; and vary the minimum amount of bonds that are required to be outstanding following the equity clawback redemption.

Example provision 3 illustrates this optional redemption feature.

Defeasance, and satisfaction and discharge

Related to redemption rights are customary provisions in high-yield bond indentures that allow the issuer to reduce or eliminate the effectiveness of restrictive covenants by placing sufficient proceeds with the trustee in trust for the benefit of the bondholders, which proceeds will be applied to pay interest and principal (and any premium) on the bonds when due, whether through maturity or in connection with a redemption of all of the bonds.

Example provision 3

Equity clawback provision

At any time prior to [date] , the Issuer may on any one or more occasions redeem up to 35% of the aggregate principal amount of notes issued under the indenture, upon not less than 30 nor more than 60 days' notice, at a redemption price equal to [XX] % of the principal amount of the notes redeemed, plus accrued and unpaid interest, if any, to the date of redemption (subject to the rights of holders of notes on the relevant record date to receive interest on the relevant interest payment date), with the net cash proceeds of an Equity Offering by the Issuer or a contribution to the Issuer's common equity capital made with the net cash proceeds of a concurrent Equity Offering by the Issuer's direct or indirect parent; provided that:

1. at least 65% of the aggregate principal amount of notes originally issued under the indenture (excluding notes held by the Issuer and its Subsidiaries) remains outstanding immediately after the occurrence of such redemption; and
2. the redemption occurs within [XX] days of the date of the closing of such Equity Offering.

'Equity Offering' means any public or private sale of common stock or Preferred Stock of the Issuer or any of its direct or indirect parent companies (excluding Disqualified Stock), other than:

1. public offerings with respect to the Issuer's or any direct or indirect parent company's common stock registered on Form S–8;
2. issuances to any Subsidiary of the Issuer; and
3. any such public or private sale that constitutes an Excluded Contribution.

Legal defeasance and covenant defeasance

Defeasance in the typical high-yield bond indenture allows issuers to terminate the effectiveness of covenants and other provisions in specific bonds.

Defeasance comes in two varieties:

- Legal defeasance.
- Covenant defeasance.

While covenant defeasance allows the issuer to eliminate the effectiveness of a group of specified restrictive covenants, legal defeasance provides that all obligations of the issuer with respect to those bonds will be discharged.

For historical reasons, the customary defeasance provisions require the satisfaction of a number of conditions, most notably the delivery of tax opinions of counsel to the effect that the defeasance will not result in adverse tax consequences to holders or cause holders to recognise income at a different time, or in a different amount or manner, than if the issuer had not affected a legal defeasance of the bonds.

While this opinion is likely to be possible to render in connection with covenant defeasance, it is not possible to render this opinion under current IRS rulings with respect to legal defeasance without a change in IRS rulings or US federal income tax law. As a result, defeasance is very rarely utilised and, when it is, only covenant defeasance is practically available.

Satisfaction and discharge

Very similar to defeasance, satisfaction and discharge provisions allow for the discharge of the entire indenture under which the bonds are issued.

Example provision 4

Satisfaction and discharge

The Indenture will be discharged and will cease to be of further effect as to all Notes, when either:

1. all Bonds theretofore authenticated and delivered, except lost, stolen or destroyed Notes which have been replaced or paid and Bonds for whose payment money has theretofore been deposited in trust, have been delivered to the Trustee for cancellation; or
2. (a) all Bonds not theretofore delivered to the Trustee afor cancellation have become due and payable by reason of the making of a notice of redemption or otherwise, will become due and payable within one year or may be called for redemption within one year under arrangements satisfactory to the Trustee for the giving of notice of redemption by the Trustee in the name, and at the expense, of the Issuer, and the Issuer or any Guarantor has irrevocably deposited or caused to be deposited with the Trustee as trust funds in trust solely for the benefit of the Holders of the Bonds, cash in US dollars, Government Securities, or a combination thereof, in such amounts as will be sufficient without consideration of any reinvestment of interest to pay and discharge the entire indebtedness on the Bonds not theretofore delivered to the Trustee for cancellation for principal, premium, if any, and accrued interest to the date of maturity or redemption; (b) no Default (other than that resulting from borrowing funds to be applied to make such deposit and any similar and simultaneous deposit relating to other Indebtedness and, in each case, the granting of Liens in connection therewith) with respect to the Indenture or the Bonds shall have occurred and be continuing on the date of such deposit or shall occur as a result of such deposit, and such deposit will not result in a breach or violation of, or constitute a default under, the Senior Credit Facilities or any other material agreement or instrument (other than

> the Indenture) to which the Issuer or any Guarantor is a party or by which the Issuer or any Guarantor is bound (other than that resulting from borrowing funds to be applied to make such deposit and any similar and simultaneous deposit relating to other Indebtedness and, in each case, the granting of Liens in connection therewith); (c) the Issuer has paid or caused to be paid all sums payable by it under the Indenture; and (d) the Issuer has delivered irrevocable instructions to the Trustee to apply the deposited money toward the payment of the Bonds at maturity or the redemption date, as the case may be.

High-yield indentures do not, however, customarily require the tax opinions required for defeasance to be rendered in connection with satisfaction and discharge. As a result, satisfaction and discharge provisions are available and sometimes utilised as an alternative to tender offers and optional redemptions, particularly in connection with refinancing transactions in which covenants, collateral or other provisions of existing bonds conflict with the terms of a new bond issuance.

Example provision 4 above illustrates a common satisfaction and discharge provision.

Tender offers

The most common approach to prepaying high-yield bonds in connection with a refinancing transaction is to undertake a tender offer for the outstanding bonds.

Unlike redemption rights, issuers cannot force bondholders to tender their bonds, so they have to use the tender price and other features to incentivise bondholders to participate in the tender offer. For example, debt tender offers are often combined with consent solicitations (called 'exit consents' as consents are obtained from bondholders as they exit their ownership of those bonds) to remove most of the covenant provisions, events of default and other terms of the bonds as an incentive (called a 'covenant strip' consent).

The price that issuers offer to bondholders is usually determined in consultation with the liability management group at one or more investment banks acting as dealer managers, a role in which the bankers will reach out to bondholders to help the issuer convince bondholders to participate in the tender offer. This price is usually tied to the redemption price that the issuer would otherwise have to pay to redeem the bonds.

If the price is substantially the same as redemption, then why would issuers utilise tender offers? The reason is because whereas redemptions usually require 30 days' notice before the bonds can be repaid, a tender offer can be structured in tandem with a new capital raise meaning the purchase date for the bonds can be better aligned with the closing of the capital raise.

Furthermore, most redemption provisions do not allow issuers to conditionally redeem bonds (for example, by conditioning the redemption on the closing of a new financing transaction), whereas a tender offer can be conditioned in a wide range of ways. Tender offers also have been structured to comply with applicable federal securities laws (most notably the requirement that tender offers be open for at least 20 business days), but still allow bonds to be refinanced in a shorter period, generally within ten business days of commencing the tender offer.

Liability management groups and attorneys have devised a range of creative tender offers that issuers may pursue, but attention must be paid to complying with applicable securities laws.

Exchange offers

Similar to tender offers, exchange offers afford issuers the ability to offer a new security in exchange for the outstanding bonds.

This is not a typical approach for issuers that are able to access the capital markets as it is far more efficient to combine a tender offer or redemption with a new capital raise to refinance outstanding bonds. This type of refinancing often achieves effectively the same result as an exchange offer because the typical bondholders in a new capital raise will include the existing bondholders, particularly if the capital raise is a new bond issuance. If issuers are not able to access the financial markets to refinance outstanding bonds because, for example, the issuer is financially distressed or the debt markets are 'closed' for new issuances, they will often approach existing bondholders to negotiate exchanging the existing bonds for a new instrument, which will usually have a new coupon and maturity date reflective of the issuer's financial position and the health of the financial markets.

As with tender offers, liability management and restructuring professionals have developed a wide range of approaches to obtaining a successful exchange offer. However, exchange offers also implicate federal (and possibly state 'blue sky') securities laws because the new securities are treated as being offered and sold and will, therefore, be required to be registered with the Securities and Exchange Commission or offered in a manner that satisfies available exemptions from registration, most notably private placements or exchanges relying on Section 3(a)(9), as amended, of the Securities Act of the Securities Act of 1933.

Issuers must also be aware that certain exchange offers may be viewed as 'distressed' offers, which rating agencies could treat as equivalent to being in default and adjust their ratings of the securities to reflect this condition. ♦

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