Simpson Thacher

Leveraged Finance 101:
A Covenant Handbook

Simpson Thacher & Bartlett LLP

Simpson
Thacher

In 1998, at the depths of the Russian debt crisis, the leveraged finance team at Simpson Thacher had some time on their hands, so we set about to create a treatise on high yield debt. Having just been reissued in its seventh edition, we believe that our *The Definitive Guide to High Yield Covenants* remains the premier guide to the intricacies of high yield debt securities for issuers, bankers and practitioners, and demand for the *Definitive Guide* has grown with the market.

While the devil may be in the details in leveraged finance, we have long recognized that a more straightforward primer is sometimes more helpful and appropriate. In that light, we created *Leveraged Finance 101: A Covenant Handbook*.

This *Covenant Handbook* consists of two concise guides, which cover the covenants for each of the key leveraged finance markets. The *Concise Guide to High Yield Notes* explains the key impacts of high yield covenants on the financial and strategic flexibility of issuers, as well as the typical areas of focus for investors in high yield debt securities. The *Concise Guide to Credit Financing* provides a primer on the differences between the covenants and other key terms found in loan financings and those in high yield debt securities.

We hope you find this *Handbook* to be a useful tool and, of course, if you have any questions or would like a copy of *The Definitive Guide to High Yield Covenants*, please do not hesitate to contact us at LevFin@stblaw.com. We have a preeminent position in the leveraged finance markets and would be happy to be of service.

The Simpson Thacher Team

Simpson
Thacher

Concise Guide to High Yield Notes

Introduction

This *Concise Guide to High Yield Notes* is meant to be exactly that — a clear overview of the typical high yield covenant package with a focus on the basic structure and principles of the covenants. Some readers may find it useful in preparing for a negotiation of business terms in a high yield transaction. Others may use it as an introduction to our *Standard Form* and as a prelude to digging deeper into specific provisions.

This *Concise Guide to High Yield Notes* is not an explanation of every term or even every covenant that you may encounter in negotiating a high yield deal, which would have produced a guide that was far from concise. As a result, you will find exceptions to many of the basic provisions we describe. But even when you encounter exceptions, we think you will recognize the basic architecture of a high yield deal that we outline in the following pages.

Organization

We have organized this *Concise Guide to High Yield Notes* in the following order:

- *crucial concepts* that we highlight to set the stage for the discussion of the covenants;
- the *restricted payments covenant* limiting dividends, distributions, redemptions of junior capital and investments;
- the *debt and lien covenants* limiting the ability to incur unsecured and secured debt and which, together with the restricted payments covenant, are usually the most heavily negotiated;
- the *asset sale* and *change of control* covenants;
- covenants governing additional *"plumbing" matters*: transactions with affiliates, limitations on subsidiary distributions, mergers and reporting;
- *optional redemption provisions*; and
- *key definitions* of Consolidated Net Income and Consolidated EBITDA.

The order of our guide does not follow the order in which you typically find these provisions in an offering document or an indenture. Instead, we begin with the most negotiated covenants and then highlight crucial concepts they illustrate through the rest of the covenant package.

Crucial Concepts

A Delicate Balance

High yield covenants always seek to strike a delicate balance that requires the collaboration of issuers with the underwriters or initial purchasers who resell the high yield notes to investors:

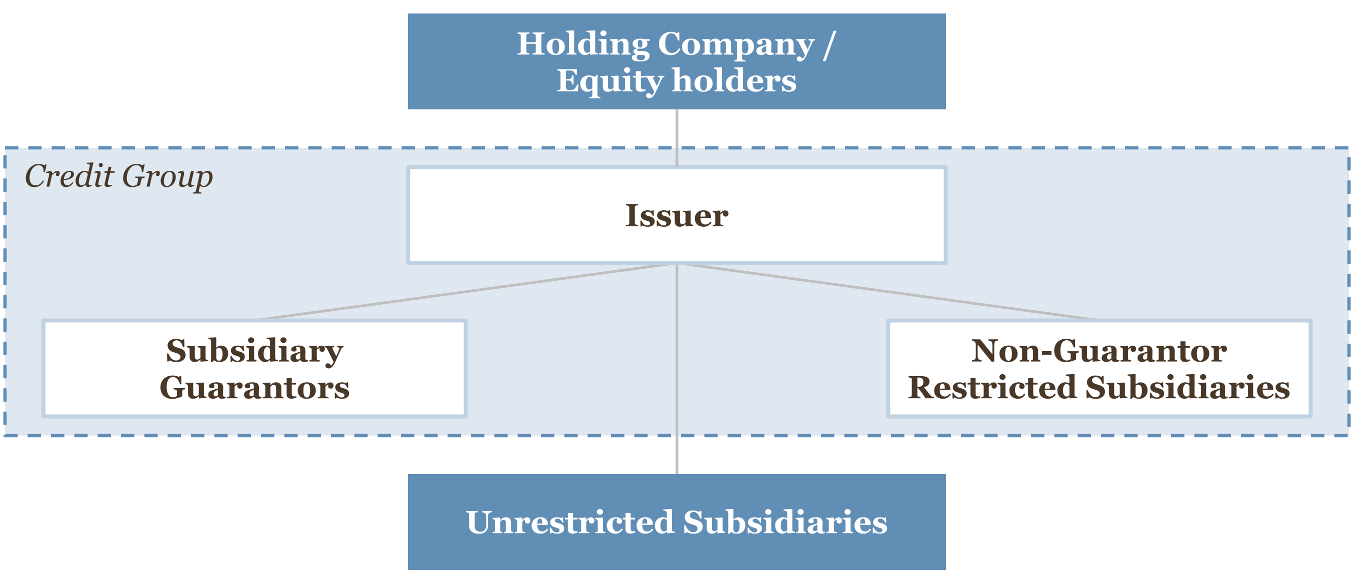
- On the one hand, the covenants provide protection for high yield investors against an issuer's overextending itself or unwisely using cash (*i.e.*, the covenants seek to preserve cash/assets and/or cash flow).
- On the other hand, the covenants must provide flexibility for the issuer to operate its business and grow over the life of the notes.

In other words, the covenants protect the investors' ability to be paid principal and interest on the notes while preserving the issuer's ability to run its business and grow without undue restrictions.

Restricted and Unrestricted Subsidiaries

High yield covenant packages are focused on regulating the ability of the issuer and its "restricted subsidiaries" to service their debt and achieve the delicate balance described above. "Restricted Subsidiaries" are subject to the covenants, and their consolidated net income and consolidated EBITDA are included when calculating the important ratios and baskets that are employed in several of the covenants. Those restricted subsidiaries include <u>both</u> subsidiaries that guarantee the notes and subsidiaries that do not provide guarantees.

Said another way, each high yield covenant package regulates only the activities of the "credit group," or the entities in the "credit box" shown below.



High yield covenants are flexible in permitting transactions between the issuer and its restricted subsidiaries or among restricted subsidiaries — in many cases, whether or not those restricted subsidiaries are guarantors or non-guarantors. In other words, there is significant flexibility across the "restricted group."

What high yield covenants do not reach (for the most part) are unrestricted subsidiaries, which are subsidiaries that the issuer specifically designates as beyond the scope of the covenant package. As a result, there are some significant implications to designating a subsidiary as "unrestricted":

- the issuer usually cannot count that subsidiary's net income when it calculates consolidated net income (and related financial metrics / ratios) unless the issuer actually receives cash from the unrestricted subsidiary; and
- most interactions between the credit group (the issuer and its restricted subsidiaries), on one hand, and an unrestricted subsidiary, on the other, are treated as if they were transactions with an unrelated third party and must comply with all the covenants.

Because of these limitations, unrestricted subsidiaries are relatively rare, but you will encounter them, for example, when a subsidiary cannot be subject to the covenants for regulatory or other business reasons (*i.e.*, project finance) or if an issuer intends to sell or merge a subsidiary.

Incurrence vs. Maintenance

High yield covenants are incurrence tests rather than maintenance tests. Unlike a traditional credit agreement, which requires an issuer to meet quarterly maintenance covenants (such as leverage ratios and interest coverage ratios), high yield covenants are usually tested only when an issuer or a restricted subsidiary actually does something — like pay a dividend, incur debt or grant a lien. This theme underlies almost all the covenants.

Made to Last

High yield covenants are designed to last for the entire term of the notes, which is typically seven to ten years. High yield indentures are generally difficult and expensive to amend, and this is a primary reason that high yield covenants are more flexible than traditional credit agreement covenants. Credit agreement amendments are fairly common, and credit agreement covenant packages are often designed to require a borrower to seek consent from its lenders for noteworthy departures from its ordinary course of business.

High yield notes, however, are securities that are usually widely held, and high yield investors traditionally do not expect to be approached for consent, except in special circumstances. In addition, unlike the administrative agent under a typical credit agreement, the trustee under a high yield indenture will not closely monitor or be in frequent contact with an issuer.

As a result, amending a high yield indenture requires a formal consent solicitation process that follows an established market practice. If that consent solicitation is coupled with a tender offer for the notes, the tender offer must also follow the federal securities laws and the specific rules of the SEC that govern tender offers.[1]

With those concepts in mind, we now turn to the first covenant.

Limitation on Restricted Payments

We start with the restricted payments covenant, often called the "RP covenant," because it goes to the heart of the high yield covenant structure — and because it's one of the most negotiated covenants.

The RP covenant regulates the amount of cash and other assets that are allowed to flow out of the "credit box" that we described in *Crucial Concepts*. This covenant walks a "delicate balance between the different goals of the issuer and its investors:

- the issuer's desire to invest in its business;
- the issuer's desire for flexibility in managing the different equity and debt tranches of its capital structure;
- the noteholders' desire to preserve the issuer's cash flow for debt service; and
- equity holders' desire to receive dividends and other returns on their investments in the issuer.

The RP covenant has an ambitious goal: to balance these interests in a way that gives everyone what they want (or at least some degree of what they want) throughout the life of the notes.

To do this, the typical RP covenant first defines "restricted payments" to include:

- cash dividends and other distributions;
- the redemption or repurchase of the issuer's capital stock;
- the redemption or repurchase of subordinated debt obligations prior to their scheduled maturity; and
- "restricted investments," which are investments that are not listed as "permitted investments."

After defining restricted payments, the typical RP covenant has three keytypes of exceptions:

- the "builder basket," which allows the issuer to build its capacity for restricted payments over time;
- negotiated exceptions (also referred to as "baskets") that the issuer can use even if it hasn't been able to build capacity under the builder basket; and
- a list of permitted investments.

[1] We are assuming that the high yield notes are sold in several U.S. states and are subject to the U.S. federal securities laws.

The "Builder Basket"

One of the quintessential features of a high yield covenant package is the builder basket, which reflects a simple compromise between the desires of the issuer (and its equity holders), on one hand, and the noteholders, on the other. All of these parties are united in one goal: they want the issuer to generate as much income and cash flow as possible. To this end, the builder basket encourages the issuer to grow the pie for everyone and slices the pie so that half of the net income it generates can be used for restricted payments, and the other half is reserved for the needs of the business, including debt service.

The issuer generally can make restricted payments in an aggregate amount that includes:

- 50% of cumulative consolidated net income since the issue date, but *minus* 100% of any consolidated net loss; *plus*
- 100% of the net cash proceeds, or the fair market value of non-cash proceeds, from the sale or issuance of common equity or from capital contributions; *plus*
- the amount of debt converted into common equity; *plus*
- net reductions in restricted investments.[2]

However, before an issuer can use the builder basket, it must be sure that (1) there is no default under the indenture and (2) it would be able to incur $1.00 of debt under the fixed charge coverage ratio (or leverage ratio, in a limited number of deals) described under "Limitation on Debt" below, which is an indication of the issuer's financial health.

A word of caution before we move on: In high yield, the financial definitions that flow through the covenants are not always what they seem. Although the RP builder basket is based on consolidated net income, the definition is heavily negotiated and usually excludes a number of items. We explain these financial definitions in more detail under "Consolidated Net Income and EBITDA."

Key Restricted Payment Baskets

The RP covenant recognizes that issuers may need or want to make certain types of restricted payments even if they have no capacity under the builder basket. And the covenant also permits certain restricted payments that have no significant effect on the issuer's ability to pay interest and principal on the notes. Here are some of the common exceptions:

- exchanges of capital stock, redeemable stock[3] or subordinated obligations of the issuer for capital stock of the issuer;
- refinancing of subordinated obligations with subordinated obligations;

[2] In a few industries, you will see other formulas. Largely for historical reasons, for example, telecommunications, media and technology companies often have an RP builder based on 100% of Adjusted EBITDA *minus* 1.4 times consolidated interest expense.

[3] *Redeemable stock* (sometimes known as *disqualified stock*) is capital stock that is treated as debt because it is mandatorily redeemable, convertible into debt or redeemable at the option of the holder during the life of the notes or during the 91-day bankruptcy preference period after the notes mature.

- redemptions of subordinated obligations pursuant to asset sale or change of control covenants in other debt instruments;
- redemptions of management equity;
- for public companies, a basket for periodic dividends;
- a general restricted payments basket; and
- in many deals, an unlimited basket for restricted payments, so long as the issuer meets a negotiated leverage ratio.

Often, the most heavily negotiated features of the RP covenant are the general restricted payments basket, the leverage ratio-based exception (if there is one) and specific exceptions that an issuer may request because of its particular capital structure, business or announced share repurchases and/or dividend policy.

"Dinging the Builder"

The exceptions described above increase the issuer's flexibility in operating its business and managing its capital structure. Keep in mind that use of some of these exceptions "dings," or reduces, the builder basket, and those reductions could even cause the builder basket to be a negative number.

This is often a negotiated point, but in general, the baskets that can be used to send cash to equity holders, such as the general restricted payments basket, will often "ding the builder." Here's an example:

Example:

Company A wants to pay a $50 dividend. It has accumulated $100 in its builder basket and has a $50 general restricted payments basket. The RP covenant stipulates that payments made under the $50 general restricted payments basket "ding the builder." So if Company A uses the general restricted payments basket to pay the dividend, its builder basket will be reduced to $50 (as it would if the builder basket were used to pay the dividend).

Note that the permitted investments described below are not treated as restricted payments and, therefore, never "ding the builder."

Permitted Investments

The last component of the RP covenant is the definition of "permitted investments," which lists the investments that the issuer and its restricted subsidiaries can make, regardless of capacity under the builder basket. Some of these are ordinary course investments, and others are specifically tailored to the issuer's business. The key permitted investments often include the following:

- intercompany investments in the issuer or a restricted subsidiary;
- investments in a person in a similar business that becomes a restricted subsidiary or merges into the issuer or a restricted subsidiary as a result of the investment;

- investments in cash and cash equivalents;
- guarantees issued in accordance with the debt covenant;
- investments in joint ventures and unrestricted subsidiaries; and
- a general permitted investments basket.

Before we move on, it's worth pausing for a moment on the exception that permits investments in a person that becomes a restricted subsidiary or merges into the issuer or its restricted subsidiaries as a result of the investment. This unassuming exception is one of the most flexible features of high yield covenants. Through this exception, an issuer can make unlimited acquisitions, as long as the target becomes a restricted subsidiary (or merges into the issuer or a restricted subsidiary) and the issuer complies with the other covenants in the indenture. Unlike many syndicated credit facilities, high yield notes do not directly regulate the size and type of acquisitions. Instead, the high yield covenant package generally permits these acquisitions, as long as the target joins the consolidated "credit box," allowing the business to benefit from the net income and cash flow it generates.

Reclassification

Some indentures include a reclassification concept that permits the issuer to divide, classify and even retroactively reclassify its restricted payments (and in some indentures, permitted investments) among different baskets.

> *Example*:
>
> Company A wants to pay a $50 dividend. Company A has $0 in its builder basket and a $50 general restricted payments basket. Company A uses its general restricted payments basket to pay the $50 dividend, using up that basket. A year later, Company A has accumulated $100 in its builder basket and is otherwise able to use the builder basket. Since its indenture allows for reclassification, Company A may now reclassify the dividend payment as if it had originally used the builder basket to pay the dividend, which would reduce the builder basket to $50 **and** would give Company A access to the full $50 general restricted payments basket, permitting it to make dividends later even if it then cannot use the builder basket.

We now move on to the second of the two most heavily negotiated covenants, the debt covenant.

Limitation on Debt

The debt covenant restricts how much debt the issuer can incur and the type of debt that it can incur. High yield issuers often have significant debt to begin with (one of the reasons they are high yield issuers and not investment grade issuers) and may need to incur more debt over the life of the notes for working capital, to refinance existing debt and to grow the business.

High yield investors care very much about leverage and, when analyzing an issuer, often ask themselves, "How much debt am I comfortable letting the company incur, and how much of that debt can be senior to me?"

It's important to remember that the debt covenant, like other high yield covenants, is an incurrence covenant, which means that it's tested only when debt is incurred. This is a crucial distinction from the maintenance covenants that you find in traditional credit agreements, which often require the borrower to test a leverage ratio, interest coverage ratio or other ratios every quarter. A high yield debt covenant is more flexible because there is no periodic testing of leverage or other financial metrics — the issuer only has to worry about the debt covenant at the time it incurs debt.

The debt covenant goes hand in hand with the lien covenant, which we will describe after this.

High yield debt covenants have two main components: the ability to incur "ratio debt" and a series of negotiated baskets and exceptions. But first, it's worth pausing to consider the definition of "Debt."

What is "Debt"?

The typical high yield debt covenant governs the incurrence of traditional debt, such as debt for borrowed money, bonds, notes and capital leases that appear on the balance sheet. But the debt covenant also encompasses other obligations that may not strike you as traditional "debt" of the issuer, including:

- net hedging obligations;
- obligations of other persons that the issuer or its restricted subsidiaries guarantee or secure;
- the mandatory redemption or repurchase price of "redeemable stock" of the issuer and its restricted subsidiaries;[4] and
- the principal amount, redemption price or liquidation preference of preferred stock of restricted subsidiaries (or sometimes simply non-guarantor subsidiaries).

Whether or not these items appear on the balance sheet, they have the potential to become "debt-like" obligations. Therefore, high yield covenants treat them as debt.

Ratio Debt

The "ratio debt" component of the debt covenant prohibits the issuer and its restricted subsidiaries from incurring debt unless it meets a specified financial ratio — usually a "fixed charge coverage ratio" of at least 2.00 to 1.00 — on a pro forma basis after giving effect to the incurrence of the debt.[5] The fixed charge coverage ratio is typically the ratio of EBITDA for the last four fiscal quarters to fixed charges, which includes interest expense (including capitalized

[4] As you will recall from our discussion of the RP covenant, ***redeemable stock*** is capital stock that is treated as debt because it is mandatorily redeemable, convertible into debt or redeemable at the option of the holder during the life of the notes or during the 91-day bankruptcy preference period after the notes mature.

[5] In a few industries, you will encounter other minimum fixed charge coverage ratios like 2.25 to 1.00 or 1.75 to 1.00. And in a few industries, you will see other formulations, such as ratio debt based on a leverage ratio (or even the ability to use either a fixed charge coverage ratio or a leverage ratio). But in the great majority of high yield deals, a minimum fixed charge coverage ratio of 2.00 to 1.00 is the norm.

interest), dividends on redeemable stock and dividends on preferred stock of restricted subsidiaries (or sometimes simply non-guarantor subsidiaries).

In other words, to incur ratio debt, an issuer needs to be generating enough EBITDA to more than cover its debt service costs. But the good news for issuers is that so long as they meet the ratio on a pro forma basis, they can incur **unlimited** unsecured debt.

It's important to remember that this covenant regulates unsecured debt and that there is a separate lien covenant that governs the granting of liens to secure debt. So if an issuer meets the ratio, it can incur unlimited unsecured debt, but if it wants to secure that debt, it needs to comply with the lien covenant.

But who exactly can use the ratio debt provision? This is often a negotiated point. The traditional formulation of the provision allows only the issuer and the guarantors to incur ratio debt. However, many deals allow the issuer and any of its restricted subsidiaries to use the basket. In these instances, any ratio debt incurred by a non-guarantor subsidiary will be structurally senior to the high yield notes being issued. To address this issue, there is often a negotiated cap on ratio debt that may be incurred by a non-guarantor subsidiary, limiting the structural subordination of the high yield notes investors' claims under the indenture.

Key Debt Baskets

The debt covenant recognizes that issuers may need or want to incur certain types of debt even if they cannot incur any ratio debt. Here are some of the common exceptions:

- debt under a credit facility or other Debt Facility (which we explain below), capped at a negotiated dollar amount, borrowing base level (for ABL facilities) and/or a specified leverage level;
- debt existing on the date of the indenture and refinancings of that debt;
- purchase money debt or capital lease obligations, capped at a negotiated dollar amount;
- acquired debt and, in some cases, debt incurred to finance an acquisition, subject to meeting a fixed charge coverage ratio test (and often permitted if the ratio simply does not get worse on a pro forma basis);
- foreign subsidiary or non-guarantor debt;
- a general debt basket;
- certain intercompany debt; and
- guarantees by the issuer or restricted subsidiaries of certain debt permitted under the debt covenant.

In addition to negotiated dollar amounts, certain of the exceptions typically include "growers" that allow the cap to increase based on a percentage of total assets, total tangible assets or, increasingly, EBITDA for the last four fiscal quarters.

The most heavily negotiated features of the debt covenant are often the Debt Facility basket and the general debt basket. Debt under the Debt Facility basket can be secured under the lien covenant, so in most transactions (except a first lien notes offering secured by the same collateral) investors know that any debt incurred under that basket will be senior to the notes.

Also, the Debt Facility is usually sized to include any incremental or "accordion" credit facility that is built into the issuer's senior credit facilities. Investors focus on the general basket because it is an open-ended basket that can be used for anything, and some deals also allow it to be secured under the lien covenant.

Debt Facility Definition

Again, the definitions are critical to this covenant. The "Debt Facility" basket (also called the "credit facility basket") was originally designed to pick up the secured bank credit facilities that are typically more senior in the capital structure than the high yield notes. However, most high yield indentures these days define "Debt Facility" or "Credit Facility" to include any issuance of debt securities, whether as a refinancing of the senior credit facilities or otherwise. So investors now typically view the "Debt Facility" basket as a general debt basket that may be secured, including any secured debt that may be incurred under the issuer's senior credit facilities.

Example:

Company A has a $50 Debt Facility basket and has used that basket to draw $50 under its credit facility. Company A wants to incur $50 of secured bonds to pay down its borrowings under its credit facility. If the definition of "Debt Facility" picks up bonds and the lien covenant allows those bonds to be secured, then Company A will be permitted to incur the $50 of secured bonds and pay down the $50 of borrowings under its Debt Facility basket without using up any other baskets.

If Company A's credit facility were a revolving credit facility, however, Company A would not want to use the Debt Facility basket to refinance outstanding revolving loans with secured bonds because doing so would prevent Company A from using the Debt Facility basket to borrow under its revolver in the future.

Reclassification

Unlike the RP covenant, where reclassification is less common, almost every indenture includes a debt reclassification concept that permits the issuer to divide, classify and even retroactively reclassify its incurrence of debt among different baskets.

Example:

Company A wants to incur $50 of unsecured debt. On Day 1, Company A is not able to incur ratio debt, so it uses its $50 general debt basket to incur the debt. A month later after a new fiscal quarter has ended, Company A is able to incur ratio debt and would have been able to incur the $50 under the ratio. Company A may now reclassify the debt incurrence as if it had used the ratio to incur the $50 to begin with, which frees up the $50 general debt basket for other uses.

The one consistent exception to the reclassification provision is that indentures generally do not permit an issuer to reclassify debt under its senior credit facilities that was incurred under the Debt Facility basket as of the closing date.

Example:

Company A has a $500 term loan incurred under a Debt Facility basket of the same size. Even if Company A is able to incur ratio debt in the future, Company A will generally not be allowed to reclassify debt under the term loan as ratio debt. In addition, there is a permitted lien basket for debt incurred under the Debt Facility basket, but that is not the case for ratio debt, which could only be secured by accessing a different permitted lien basket, if available.

Because debt incurred under the Debt Facility basket is usually effectively senior to the high yield notes (except in a first lien notes offering secured by the same collateral), allowing the reclassification of Debt Facility debt would permit a potentially unlimited amount of secured debt to be incurred ahead of the high yield notes.

A Note About the Fixed Charge Coverage Ratio and Basket "Stacking"

A final note about the calculation of the fixed charge coverage ratio before we leave the debt covenant: While you can slice and dice the baskets largely as you wish when incurring debt, issuers need to be careful when incurring ratio debt in connection with using other debt baskets.

Example:

Company A wants to incur $100 of debt, and it has the standard ratio debt provision as well as a $75 general debt basket. Let's assume that there are no other debt baskets that Company A can use to incur the new debt. Company A knows that it can incur only $80 of new debt while satisfying the pro forma 2.00 to 1.00 fixed charge coverage ratio test (i.e., if Company A incurs more than $80 of new debt, it will not be able to use the ratio debt provision). So Company A asks if it can simultaneously incur $80 as ratio debt and use $20 of its general debt basket to incur the new debt, leaving it with a $55 general debt basket. This approach has not historically been available under a typical indenture because the fixed charge coverage ratio calculation must be on a pro forma basis for all the debt incurred at that time. As a result, if Company A wants to use the ratio debt provision, it must meet the 2.00 to 1.00 fixed charge coverage ratio on a pro forma basis for the incurrence of the full $100 of new debt.

However, to address this issue, indentures increasingly include "stacking" provisions. These provisions allow issuers to "stack" debt incurred in reliance on fixed baskets on top of debt incurred in reliance on the ratio test when the applicable ratio would not have been satisfied had the ratio been calculated inclusive of the fixed basket amount.

We now move to the liens covenant, which goes hand in hand with the debt covenant.

Limitation on Liens

As we explained earlier, when an issuer decides to incur secured debt, it needs to comply with both the debt covenant and the lien covenant. The lien covenant is focused on protecting the high yield investors' priority in the capital structure by regulating the incurrence of secured debt that may be effectively senior to the notes and ensuring that the notes have a senior priority lien on collateral that secures any junior debt.

In a secured notes offering, the lien covenant seeks to limit the amount of secured debt that will compete with the secured notes for collateral. On the other hand, in a subordinated or senior subordinated notes offering, there is typically no prohibition on incurring liens to support senior debt. The rationale for this is that those noteholders have already agreed to a junior position in the capital structure, and permitting liens to secure senior debt should be of little consequence to them.

Equal and Ratable Clause

In an unsecured notes indenture, it is important to keep in mind that the lien covenant is not a blanket prohibition on the incurrence of secured debt. The lien covenant simply prevents the issuer and its restricted subsidiaries from encumbering assets to secure other debt unless the notes are equally and ratably secured. Not surprisingly, a first lien secured notes indenture does not include an equal and ratable clause because this clause would allow the potentially unlimited dilution of the collateral that the investors are counting on to support the debt.

Key Lien Baskets

The lien covenant contains a very important exception for "Permitted Liens," and it is here that most of the negotiation is focused. Over the years, the laundry list of exceptions included in the definition of "Permitted Liens" has grown, and many of these exceptions reflect ordinary course liens that are usually not a major concern to investors. However, there are a handful of important exceptions that include the following:

- liens incurred to secure debt under the Debt Facility basket;
- liens incurred to secure debt under the purchase money debt/capital lease basket;
- liens incurred to secure debt existing on the date of the indenture;
- a general lien basket; and
- in some transactions, liens securing additional secured debt so long as the issuer meets a pro forma secured leverage ratio test (see below for more details).

In many deals, issuers also have the ability to secure the general debt basket and occasionally other baskets.

Definitional Pitfalls

There are a couple of definitional items that we wanted to flag for you before moving on.

The "If You Can Incur It, You Can Secure It" Pitfall

Typically, the "Permitted Lien" exception relating to the Debt Facility basket is a cross reference to that basket. For example, the "Permitted Lien" exception may refer to "Liens securing clause (1) of the second paragraph of the debt covenant," which typically is the Debt Facility basket discussed above. However, we have seen indentures, particularly in certain industries, that permit something to the effect of "liens securing Debt Facilities."

By eliminating the explicit cross reference to the Debt Facility basket, this slight change in wording allows an issuer to secure any Debt Facility (which, as you remember from the discussion of the debt covenant, usually includes capital markets offerings), including ratio debt. Under this formulation, as long as an issuer is able to incur ratio debt that can be characterized as a Debt Facility, it can secure that debt. In an unsecured deal, this could lead to potentially unlimited secured debt that would be effectively senior to the notes.

Instead, investors usually want to be able to quantify the debt that may be incurred ahead of the notes. In most cases, they will insist that the Permitted Lien exception for Debt Facilities be tied specifically to the related exception to the debt covenant.

Secured Leverage Ratios – the Hidden "Net" and Revolving Facility Debt

In the last bullet point under "Key Lien Baskets," we noted that some indentures allow an issuer to incur additional secured debt so long as it meets a pro forma secured leverage ratio test. Traditionally, this secured leverage ratio is calculated as the ratio of secured debt as of the most recent balance sheet date to EBITDA for the last four fiscal quarters, pro forma for the incurrence of the new debt.

However, in analyzing the provision, it is critical to work through the definitions. In some indentures, the secured debt that is measured is limited to certain kinds of debt (the same is true of unsecured leverage ratios, if they appear in an indenture). In other indentures, secured debt is calculated net of cash and cash equivalents (or unrestricted cash and cash equivalents), sometimes capped at a specified dollar amount. If the issuer's business generates considerable cash and there is no cap on the cash that may be "netted" from the secured leverage ratio calculation, it may be difficult to predict the issuer's future secured debt capacity.

To avoid a scenario in which the issuer first exhausts the capacity under the secured leverage ratio basket and then draws down the full amount available under a revolving facility in reliance on the Debt Facility basket (thus potentially significantly exceeding the negotiated leverage ratio for this basket), indentures often provide that the leverage ratio is calculated assuming that all commitments under any revolving facility have been fully drawn.

We wanted to flag these pitfalls as another reminder that the definitions in an indenture are just as important as the text of the covenants themselves, and a few words in a definition can sometimes have a dramatic effect on certain business terms of the indenture.

While the restricted payments and debt / liens covenants reflect the most fundamental high yield covenants, we next turn to the covenants that may require the issuer to offer to repurchase the notes in connection with certain changes of control and asset sales.

Change of Control Covenant

This covenant is actually a put right and is often found near the beginning of the covenant package in a section entitled "Repurchase at the Option of Holders."

The change of control covenant requires the issuer to offer to purchase the notes from noteholders at a price equal to 101% plus accrued and unpaid interest if a "change of control" of the issuer occurs.

The change of control put right is a defining feature of high yield notes. The rationale for giving investors this put right is that investors purchased the high yield notes based in part on their comfort with the management and/or the controlling shareholder(s) of the issuer.

Of course, if the trading price of the notes increases (*i.e.*, above 101%) after announcement of a change of control, then holders will most likely elect not to put. In other words, if the notes trade up, that typically means that the investors are comfortable with new management and/or the new owner and would prefer to stay invested in the notes.

Note that the issuer's senior secured credit agreements typically provide that a change of control constitutes an event of default and often prohibit prepayment of other debt. As a result, when a change of control occurs, the issuer would either repay its senior secured credit facility debt or obtain consents from its lenders before repurchasing any high yield notes under the put.

Definition of Change of Control

Typically, a change of control is defined to occur when:

- a person or group obtains ownership of 50% or more of the voting stock of the issuer (in certain instances, 35% in the case of widely-held public companies);
- a merger or consolidation occurs in which the equity holders of the issuer before the transaction do not represent a majority of the equity ownership of the surviving entity;
- the issuer sells all or substantially all of its assets to any "person"; or
- the issuer adopts a plan of liquidation.

The terms "person" and "group" are meant to track the way those terms are used in determining beneficial ownership of shares for purposes of SEC reporting requirements.

Permitted Holders

When a small group of shareholders already controls an issuer (*i.e.*, a financial sponsor or a founder), most indentures carve these existing shareholders out of the change of control definition. These "permitted holders" can typically increase their stakes or buy and sell among themselves without triggering a change of control put. High yield investors usually understand that these shifts in ownership can occur within the permitted holder group and are more focused on the permitted holders' collective control of the issuer.

Double Trigger Change of Control

A “double trigger” change of control put right, which is common in the investment grade world, has increasingly been adopted by high yield issuers in recent years. In a “double trigger” change of control put, the investor put is only triggered if there is both a change of control and a ratings downgrade from one or more rating agencies within a specified period following the announcement of the change of control.

A double trigger is favorable to issuers, since the issuer is not obligated to offer to repurchase the notes if the rating agencies find that the change of control will not negatively affect the issuer’s ratings. The double trigger concept effectively shifts to rating agencies the determination as to whether the change of control is neutral or a positive for investors. Rather than permitting individual noteholders to decide whether or not to put their notes based on their views of the transaction, the double trigger provision puts rating agencies in the position of assessing the impact of the transaction on the financial health of the issuer on behalf of investors.

Double trigger change of control provisions are more common in high yield offerings for issuers that may be on the cusp of reaching investment grade status, such as issuers with split high yield/investment grade ratings from the rating agencies.

Limitation on Asset Sales

The high yield asset sale covenant is a surprisingly flexible covenant designed to regulate — but not prohibit — asset sales. This covenant may be the clearest example of high yield investors’ focus on preserving an issuer’s ability to meet its debt obligations while providing flexibility for issuers to run their businesses and execute their strategies as they see fit over the life of the notes.

Unlike a traditional credit agreement, high yield notes do not place strict limits on asset sales. Instead, the high yield asset sale covenant establishes guidelines that must be followed in any asset sale and permits the issuer to use the proceeds either to reinvest in the business (which replenishes its asset base and maintains its ability to generate cash) or to prepay debt that ranks senior or equal to the notes in the capital structure (which aligns the issuer’s cash flow requirements with its smaller asset base).

Only if the issuer does not use the proceeds from asset sales in this way (which it almost always does) is it required to offer to repurchase the high yield notes with those proceeds.

What is an Asset Sale?

Another flexible aspect of the covenant is that “asset sales” do not include every type of sale that you might imagine. “Asset sale” is broadly defined to include any kind of transfer, sale or disposition of assets, including issuances or sales of capital stock of subsidiaries. But to avoid capturing unnecessary items, the definition excludes, among other things:

- intercompany sales;
- inventory sales;
- sales of obsolete equipment;

- sales that are regulated by the merger covenant or that constitute a change of control; and
- the making of permitted investments or restricted payments, since those actions are regulated by the restricted payments covenant we described above.

In addition, there is always a *de minimis* basket that excludes any asset disposition less than a negotiated dollar threshold.

Asset Sale Requirements

Almost every asset sale covenant requires that (1) the issuer receive fair market value for the assets and (2) a specified percentage (typically 75%) of the consideration be received in the form of cash or cash equivalents. The 75% cash consideration test is generally applied to each asset sale, but in certain indentures, the test is cumulative so that the issuer can complete an asset sale with less than 75% cash consideration so long as the running tally of cash is 75% or more of the total consideration from assets sales during the life of the notes. In addition, there are a couple of interesting provisions relating to the 75% prong that are worth highlighting.

Permitted Asset Swaps

Some indentures carve out asset swaps from the 75% cash consideration prong, as long as the swaps are at fair market value and other requirements are met. This makes sense when an issuer is simply exchanging one asset for a substantially similar asset, especially in industries where swaps are common.

Designated Non-Cash Consideration

Most indentures have a “designated non-cash consideration” basket that is subject to a negotiated threshold. In other words, the issuer can receive a certain amount of non-cash proceeds and simply designate them as cash for purposes of the asset sale covenant.

Use of Asset Sale Proceeds

Once an issuer has jumped over the hurdles we describe above, the rest of the asset sale covenant is a fairly low bar for most issuers. Within the period allowed by the indenture (usually 365 days, although it can be longer or shorter depending on the issuer and the industry), the issuer must either:

- prepay debt that ranks senior in right of payment (or effectively senior because it is secured with a priority lien or, in some indentures, structurally senior because it is incurred at a non-guarantor subsidiary) to the notes;
- prepay the notes (or other *pari passu* debt as long as it prepays the notes equally and ratably); or
- reinvest in assets, other than working capital assets, that are useful in its business, which can include capital expenditures and acquisitions.

Traditional senior secured credit agreements require that net proceeds of asset sales be applied to prepay senior secured debt, so the high yield asset sale covenant allows an issuer to comply with its senior secured credit agreements — or even prepay its senior-ranking debt voluntarily. But if the issuer has cash left over, beyond prepaying the notes through open market purchases or otherwise, the asset sale covenant provides a great deal of flexibility to invest the cash in its business, especially since high yield issuers that are growing their businesses often have significant capital expenditure programs and frequently undertake acquisitions. The covenant is also flexible enough to permit issuers to temporarily pay down revolving loan borrowings and later use an equivalent amount of cash to reinvest in the business.

Asset Sale Offers

If an issuer is unable to apply the net proceeds of an asset sale in the time allowed, it must then make an offer to acquire notes at par plus accrued and unpaid interest once those excess proceeds reach a negotiated threshold. If the offer is oversubscribed, then the issuer purchases the notes on a pro rata basis. If it's undersubscribed, then the issuer can use the remainder for general corporate purposes, and the excess proceeds amount is reset to zero.

All this means that very few asset sale offers occur in practice. Because most issuers use the proceeds either to delever or to reinvest in their business, the reality is that the key components of this covenant are the fair market value and 75% cash consideration requirements. But high yield investors take comfort in knowing that the proceeds cannot automatically be used for general corporate purposes or to pay dividends without first complying with the covenant.

We next turn to the remaining key covenants, which govern an array of activities of a high yield issuer, such as merger requirements and reporting obligations. While these covenants are often less controversial and less negotiated, we have taken care to highlight potential pitfalls they may present.

Limitation on Affiliate Transactions

The limitation on affiliate transactions covenant limits the issuer's ability to enter into transactions with affiliates unless those transactions are on terms no less favorable than would be available for similar transactions with unrelated third parties. The covenant is designed to prevent value from leaking out from the credit group to affiliates that are not subject to the covenants of the indenture.

The definition of "affiliate" is typically based on the traditional SEC definition, which includes persons that control, are controlled by or are under common control with the issuer. Sometimes the definition specifies a beneficial ownership threshold (*i.e.*, 10%) above which an ownership interest is deemed to be an affiliate relationship.

Affiliate Transaction Requirements

By now, you will have noticed that high yield covenants generally limit activities but do not prohibit them, and the affiliate transactions covenant is no exception. The covenant simply sets thresholds above which special approval is required, and the covenant includes a number of exceptions that are not subject to the covenant at all.

If the transaction value is more than a negotiated threshold, then the transaction generally must be approved by a majority of the board of directors, including a majority of the independent directors who do not have an interest in the transaction.

If the transaction exceeds a higher threshold of value, traditional indentures require a fairness opinion from an independent investment bank or appraisal firm. In recent years, however, indentures increasingly have dispensed with this requirement, partly because both issuers and underwriters have realized that complex or unusual affiliate transactions can be difficult and expensive for an appraisal firm to value.

Key Exceptions

Most deals include a negotiated *de minimis* transaction threshold under which the issuer need not worry about the covenant. In addition, there are several common exceptions:

- the making of restricted payments and (most or all) permitted investments, since those are already covered by the restricted payments covenant;
- compensation and employee benefit arrangements between the issuer and its officers, directors and consultants;
- intercompany transactions;
- ordinary course transactions with customers, suppliers and joint venture partners;
- issuance of capital stock to certain permitted holders;
- in financial sponsor deals, payment of management fees to the sponsor and engagement of the sponsor's affiliates for services; and
- loans to employees in the ordinary course.

In general, although there is some negotiation of the special approval thresholds we describe above, the affiliate transactions covenant does not generate significant controversy.

Limitation on Restrictions on Distributions from Restricted Subsidiaries

This covenant is often referred to as the "no dividend stopper" covenant. It's an important covenant, but it falls into the category of covenants that are usually not highly negotiated. The covenant's purpose is to prevent an interruption in the flow of cash from subsidiaries to the issuer so that the issuer will enjoy the full benefit of the cash-generating capabilities of the consolidated entity to support its debt service requirements.

The covenant governs the ability of the issuer and its restricted subsidiaries to enter into any arrangement that would limit:

- the payment of dividends or distributions to the issuer or a restricted subsidiary;
- the making of loans or advances to the issuer or a restricted subsidiary; or
- the sale, lease or transfer of assets to the issuer or a restricted subsidiary.

Key Exceptions

The covenant contains a number of exceptions for existing “dividend stoppers,” ordinary course arrangements or arrangements that place noteholders in no worse position than existing debt agreements. The common exceptions include:

- amendments or refinancings of existing agreements, so long as they are no more restrictive than the existing encumbrances and restrictions;
- restrictions that have “come over” with acquired subsidiaries;
- restrictions arising by law;
- restrictions arising in merger and acquisition transactions;
- purchase money obligations restricting the transfer of acquired property; and
- restrictions in other permitted debt.

A cautionary note about this covenant is in order. Although it’s often not heavily negotiated, it’s crucial to pay attention to the exceptions to ensure that they contain the appropriate level of flexibility for any financing arrangements that an issuer may need to pursue over the life of the notes. If an issuer wants the ability to incur debt at a foreign subsidiary, for example, it needs to negotiate exceptions that would permit the restrictions on subsidiary distributions that are embedded in a covenant package, such as customary restricted payments and lien covenants.

Reporting

The reporting covenant aims to ensure the flow of information that high yield investors need to support trading in the notes and to monitor the performance of the issuer.

Reporting covenants can vary fairly significantly depending on whether the issuer is a public or private company, and whether the notes were issued in an SEC-registered or private transaction. To understand how the covenant works, we need to start with a bit of background on the differences between selling high yield notes in (1) a public deal, (2) a private deal under Rule 144A[6] with a later requirement to register the notes with the SEC and (3) a private deal under Rule 144A that stays private and is never registered with the SEC, which investors call “144A-for-life” or “private-for-life.”

“Back End” Registration Rights and 144A-for-Life Deals

High yield notes are typically initially sold in the 144A market. In the early days of the high yield market, securities sold in the 144A market included an obligation to complete a “back end” exchange offer, which is an offer to allow holders to exchange the privately placed securities for freely transferable, SEC-registered securities within a specified period after the closing. The “back end” requirement reduced (or even eliminated) any negative impact on the coupon rate of the notes from having been sold as (at least then) relatively less liquid 144A securities. In

[6] Rule 144A under the Securities Act of 1933 allows private resales to “qualified institutional buyers,” or “QIBs” for short. High yield notes sold under 144A are often sold concurrently to non-U.S. investors pursuant to Regulation S under the Securities Act.

addition, certain buy side investors at the time operated under investment guidelines that limited the amount of securities they could buy without "back end" registration rights.

However, after the adoption of Sarbanes-Oxley and the related SEC rules and regulations, private companies pointed to the expensive compliance burdens of the SEC's Regulation S-X, which governs the financial statements that must be included in an SEC-registered deal, and began to resist the obligation of a "back end" exchange offer. In addition, the number of 144A-for-life deals increased due to a rise in the number of secured high yield deals because the requirements of Rule 3-16 of Regulation S-X (which then required financial statements in SEC-registered deals for certain subsidiaries the stock of which are pledged as collateral) are onerous and costly. Indentures for SEC-registered notes must also comply with the Trust Indenture Act of 1939, which imposes extra requirements on issuers of secured notes.

As a result of these factors, the market has completely shifted to a default setting in favor of private-for-life deals, which are no longer considered to have a notable pricing impact, and "back end" registration rights are rarely required except in certain very large scale deals or investment grade offerings. Even when Rule 3-16 was largely superseded in early 2021 by Rule 13-02 of Regulation S-X, which requires summarized financial information for affiliates whose securities are pledged as collateral in SEC-registered deals, rather than full financial statements, the market had already shifted away from "back end" exchange offers and has not shifted back.

Reporting Requirements

The basic requirement of the reporting covenant, whether or not the issuer is a public company subject to the SEC's periodic reporting requirements, is to provide noteholders:

- an annual report containing information that would be in a Form 10-K;
- quarterly reports containing information that would be in a Form 10-Q;
- reports about certain events that contain information that would be in a Form 8-K; and
- quarterly conference calls with management.

The traditional reporting covenant requires an issuer to provide noteholders with the information that a public company would report to the SEC and often permits an issuer to deliver the information by posting it on a website.

All this makes sense for public companies and 144A deals with "back end" registration rights, which will become public companies through the registration of the notes, if they are not public already. *But what about private companies and 144A-for-life deals?*

Especially in 144A-for-life deals, issuers have been successful in negotiating modifications to these requirements. The key modifications are as follows:

- *Timing*. Private companies may need more time to prepare their annual or quarterly reports than the SEC rules allow. Some indentures, therefore, provide an extended deadline for the issuer to produce its annual and quarterly reports. And in some cases, a new high yield issuer negotiates a longer "holiday" period for its first annual report and first one or two quarterly reports. These new issuers argue that they need extra time to become accustomed to reporting according to SEC standards.

- *Content*. Indentures often require that issuers provide only the types of information in their reports that they otherwise provided in the offering document for the notes. In 144A-for-life deals, issuers often negotiate exceptions so that they will not need to provide all the information that would be required in SEC reports. These issuers argue that some information included in SEC reports may not be materially meaningful to noteholders, such as detailed executive compensation information. In fact, in some, but by no means all, 144A-for-life deals, issuers are only required to provide annual and quarterly financial statements with an MD&A discussion and may omit other disclosure (*i.e.*, risk factors or a business section) from their reports to noteholders that would otherwise appear in an SEC report.
- *8-Ks*. In 144A-for-life deals, it has become increasingly acceptable to list the Form 8-K-like reports that an issuer needs to provide, dispensing with the requirement to report certain events that may not be material to noteholders.

Additionally, in some deals, issuers also negotiate an extended grace period for the related event of default under the indenture. For example, you may see a 60-day cure period for most covenant breaches under the indenture, but a 90-day cure period for a covenant breach under the reporting covenant. These requests for an extended grace period have their roots in events several years ago when issuers with accounting-related reporting delays found their problems compounded by threatened accelerations of their notes due to their breaches of the reporting covenant.

Conference Call Requirements

In addition to providing reports to noteholders, the issuer is typically required to hold live quarterly conference calls with the opportunity to ask questions of management. We've seen underwriters and issuers debate this requirement in numerous deals. Issuers who are public companies sometimes argue that they already host earnings calls for their equity investors as a matter of course and that noteholders are free to listen in. More often than not, however, noteholders do not require a call dedicated to debt investors, but they require the comfort of knowing they will always have quarterly access to management, even if the issuer goes private and ceases to host calls for equity investors.

Multiple Levels of Reporting

Sometimes companies struggle with having to report at multiple levels. Let's take an easy example: Company A (a private company) issues notes with a traditional reporting covenant. A year later, Company A completes an IPO, but the entity that goes public is the direct parent of Company A. So that issuer is now stuck in a situation where the direct parent of Company A must file reports with the SEC, but the notes reside one level down at Company A, which still has an independent contractual obligation to provide reports to noteholders.

To address this problem, many indentures have a provision allowing a parent company's periodic reports to satisfy the reporting covenant as long as the parent guarantees the notes.

Remember that if an issuer makes use of this provision, that does not mean that the parent entity becomes subject to the covenants under the indenture. The parent can choose to provide a guarantee to enable the issuer to avoid duplicative reporting requirements, but the covenants would continue to apply only to the issuer and its restricted subsidiaries.

Mergers and Consolidations

The merger and consolidation covenant is designed to prevent a business combination in which the surviving obligor for the notes is not financially healthy, as measured by the ratio test described below. The covenant also seeks to ensure that noteholders will have enforceable rights against the surviving entity in a merger, consolidation or transfer of all or substantially all the assets of the issuer or a subsidiary guarantor.

Covenant Requirements

The typical conditions for a merger, consolidation or transfer of all or substantially all assets of the issuer include:

- the continuity of the issuer's existence or the assumption of the indenture by a U.S. successor (*i.e.*, the notes must travel with the surviving entity in the transaction);
- the absence of a default;
- the ability of the issuer to incur a $1.00 of debt under the fixed charge coverage ratio used in the debt covenant (or, very frequently, no deterioration in the fixed charge coverage ratio);
- the continued effectiveness of any guarantees of the notes; and
- the delivery of certificates and legal opinions.

The typical conditions for a merger, consolidation or transfer of all or substantially all assets of a subsidiary guarantor usually mirror those above but do not include the $1.00 of debt test, which applies only to transactions involving the issuer.

There are also a handful of customary exceptions to the covenant, including one that permits mergers of subsidiary guarantors with and into other subsidiary guarantors or the issuer. The covenant also typically permits tax-motivated reincorporations in another state or, in some cases, another country.

Interaction with Change of Control Covenant and Asset Sale Covenant

Always remember that every covenant must be tested independently to assess the implications of a given transaction. A business combination could comply with the merger and consolidation covenant but still trigger the change of control covenant described above.

On the other hand, if an issuer sells "all or substantially all" of its assets to a third party in compliance with the merger and consolidation covenant, the issuer generally will not need to comply with the asset sale covenant because the definition of "asset sale" usually carves out sales of all or substantially all assets of the issuer so long as the transaction complies with the merger and consolidation covenant.

"All or Substantially All"

One of the most interesting — or frustrating — aspects of this covenant is the ambiguity that surrounds the phrase "all or substantially all." While virtually every indenture uses some variation of that phrase, there is no bright line definition. Instead, courts tend to analyze qualitative and quantitative facts and circumstances, and the quantitative factors can include revenues, assets and operating income, weighted as the court sees fit. In the face of this uncertainty, we always encourage issuers to raise the issue with their counsel if there is any doubt about whether the business being sold may constitute “all or substantially all” of their assets.

Optional Redemption

One of the distinctive elements of high yield notes are the optional redemption provisions. As a general matter, high yield notes are not redeemable at the option of the issuer for a specified number of years to permit investors to lock in an interest rate for a significant period of time.

For example, after a five-year no-call period, ten-year notes are typically redeemable at a redemption price equal to par plus half the coupon, and the premium then declines ratably to par two years before maturity. For eight-year notes, the usual formulation is a three-year no-call period, after which the notes are redeemable at a redemption price equal to par plus 50% or 75% of the coupon, declining ratably to par on the sixth anniversary of the issuance. In older deals, eight-year notes typically had a four-year no-call period, in which case the redemption price after the no-call period is equal to par plus 50% of the coupon, declining ratably to par.

Like almost everything in high yield, there are exceptions. High yield notes usually can, in fact, be redeemed before the end of the no-call period – but generally at an expensive “make-whole” price based on the present value of future payments under the notes. And there are a couple of other exceptions that we describe below.

Exceptions to the No-Call Period

Make-Whole Redemption

Make-whole redemption allows issuers to call the notes during the no-call period at a price equal to the present value of the optional redemption price on the first optional redemption date and future interest payments up to that date. The present value for a high yield make-whole redemption is almost always calculated based on the Treasury rate plus 50 basis points, which differs from investment grade notes offerings, where the discount to the applicable Treasury rate varies and is set at pricing. Although an issuer could always launch a tender offer for the notes, the make-whole redemption provision removes the uncertainty about whether investors will tender in the offer and what price they will demand.

The Equity Claw

Another significant exception to the no-call period is the ability of an issuer to redeem a portion of the notes with the proceeds of an “Equity Offering” during the three years after the issuance date (commonly referred to as the “equity clawback” or “equity claw”). This exception, which is nearly universal in high yield offerings, permits the issuer to delever after an IPO or after raising additional equity capital.

Note that the length of this redemption period is not tied to the no-call period but is almost always a three-year period. You will typically see exceptions only for shorter maturity notes, such as a five-year note with an “equity claw” for the first two years after issuance.

Traditionally, issuers were not permitted to redeem more than 35% of the original principal amount of the notes in an equity "clawback," although 40% has become increasingly common. The issuer must pay a redemption price to investors equal to par plus a premium equal to the full coupon, plus accrued interest. While not a cheap option, it is cheaper than using the make-whole redemption provision and helps issuers tell the equity market a deleveraging story in connection with an IPO.

Keep an eye on the definition of "Equity Offering," as certain transactions permit an equity clawback only with the proceeds of an IPO or follow-on public offering, while some deals broaden the definition to include any public or private equity offering, particularly if the issuer is a portfolio company of a financial sponsor or in an industry in which companies partner with strategic investors.

Equity clawback provisions typically require the issuer to apply the proceeds of an equity offering to the redemption of the notes within a specified period of time (generally within 60 to 90 days). In addition, equity clawback provisions also require a certain percentage (*i.e.*, 60-65%) of the originally issued notes to remain outstanding following completion of the redemption in order to preserve sufficient liquidity for the remaining notes.

The Interaction among the Redemption Exceptions

These redemption features are not mutually exclusive. In other words, you can use one or more of the redemption features at the same time. Here is an example:

<u>*Example*</u>:

Company A issued $100 million aggregate principal amount of 6% eight-year notes with a four-year no-call period, and the notes contain both the "equity claw" and make-whole redemptions described above. In Year 3 of the no-call period, Company A goes public and wants to redeem all of the outstanding notes in connection with the IPO. Let's assume Company A receives $100 million of net proceeds from its IPO. As a result, it can redeem 35% of its notes at 106% using the "equity claw" and redeem the rest of the notes using the make-whole redemption provision.

"Clean up" Redemption Following a Repurchase

Increasingly, high yield indentures include permit an issuer to "clean up" and redeem all of the remaining notes in the event holders put 90% or more of the outstanding principal amount of a high yield series in a Change of Control Offer (at a price of 101%), Asset Sale Offer (at a price of par) or other tender offer (at the tender offer price). This logical provision allows an issuer to avoid a small stub trading in an illiquid tranche and avoids the need for covenant compliance by an issuer with a small tranche held by investors that have the concentrated ownership power to exert undue influence and elevate the price for waivers in the event the issuer needs covenant relief.

Key Definitions: Consolidated Net Income and EBITDA

In this *Concise Guide to High Yield Notes*, we have focused on a high-level overview of the high yield covenant package. But, as always, the devil is in the details, and a lot of those details reside in the definitions contained at the back of the description of notes.

We encourage you to review the Standard Form for a full listing and description of the definitions, but we wanted to flag two key definitions that are among the fundamental building blocks to the financial ratios used in the covenant — and for that reason are among the most negotiated definitions.

Consolidated Net Income

Consolidated Net Income is the basis for most of the financial ratios contained in a high yield indenture, since the definition of Consolidated EBITDA used to calculate the fixed charge coverage ratio and other ratios begins with an issuer's Consolidated Net Income. In addition, as you will remember, the RP "builder basket" used for making restricted payments gives an issuer credit for 50% of its Consolidated Net Income.

Consolidated Net Income always begins with consolidated net income of the issuer and its restricted subsidiaries in accordance with GAAP. But it then goes on to exclude a number of items that either reflect value that may not be accessible for payment of the notes or are viewed as unrealized, non-recurring or not reflective of the issuer's ongoing operations.

For example, Consolidated Net Income often excludes items like the following, among others that may be tailored to the issuer's business and industry:

- income from unrestricted subsidiaries or equity investments (unless the issuer actually receives cash);
- income (but not losses) of subsidiaries that are blocked from distributing earnings to the issuer because of contractual, regulatory or other restrictions;
- extraordinary gains or losses; and
- income or losses from sales of assets outside the ordinary course of business.

Why does Consolidated Net Income usually exclude extraordinary items? Primarily because high yield investors are keenly aware that 50% of Consolidated Net Income can be used for restricted payments (*i.e.*, cash exiting the "credit box"), and high yield investors prefer that the RP "builder basket" be based on a definition that closely follows a GAAP term, albeit with a few select exclusions, such as extraordinary items.

Consolidated EBITDA

Consolidated EBITDA is the basis for calculating the fixed charge coverage ratio (which is used in the debt covenant, the RP covenant and the merger covenant) and for calculating leverage ratios and, in some cases, "grower" baskets in those indentures that have them. Consolidated

EBITDA begins with Consolidated Net Income and adds back consolidated interest, taxes, depreciation and amortization, and other negotiated items.[7]

In general, Consolidated EBITDA permits an issuer to add back any non-cash charges unless those charges reflect an accrual for a future cash payment, and that practice is generally accepted in the market. The negotiations over add-backs in the definition of Consolidated EBITDA usually center on items that are non-recurring but are cash charges or that do not meet SEC guidance on reporting non-GAAP metrics. For example, restructuring charges representing an accrual for cash severance payments to employees is the type of add-back that investors may push to limit to a negotiated dollar cap.

Another example is the frequent and often heavily negotiated request to add back cost savings that are achieved from certain acquisitions, mergers or dispositions. For example, issuers and underwriters may negotiate whether the cost savings must occur within a specified period of time after the closing date (*e.g.*, 12 to 18 months). In addition, you will often see a negotiated cap on this add-back, whether as a fixed dollar amount or as a percentage of total Consolidated EBITDA.

Again, every indenture is different, and the definition is typically tailored to the issuer's particular business and industry, as well as other debt agreements.

It's important to keep in mind that virtually every high yield offering uses an adjusted EBITDA metric as a marketing tool and presents a calculation in the summary box at the front of the offering memorandum. It's in everyone's interest to make sure that the adjusted EBITDA shown in the front of the offering memorandum is consistent with the definition in the high yield covenant package. Also, high yield investors will want an issuer to report its "EBITDA" every quarter in a manner that is consistent with the covenant definition so that investors can monitor whether the issuer has the capacity to meet the financial ratios under the indenture.

The Battle of the Add-Backs

You may have noticed that excluding a non-recurring charge from Consolidated Net Income would have the same effect as adding back that charge in calculating Consolidated EBITDA (if the charge had been excluded in calculating Consolidated Net Income). So why go through the trouble of having separate definitions for Consolidated Net Income and Consolidated EBITDA?

The answer to this question lies in where the two definitions are used and how they are understood by the high yield market. High yield investors are used to evaluating leverage and interest coverage based on Consolidated EBITDA, which is a commonly reported metric for high yield issuers and closely followed by analysts and investors. So a fixed charge coverage ratio that uses Consolidated EBITDA is a natural tool for measuring whether an issuer is able to incur more debt.

But Consolidated EBITDA does not necessarily reflect the cash that an issuer is actually generating, and investors feel less comfortable using it as a guide to how much cash may leave the "credit box" under the RP covenant. As a result, the RP "builder basket" is generally based on Consolidated Net Income, excluding certain items as we describe above.

[7] In some indentures, the defined term is "EBITDA" or "Consolidated Cash Flow."

Because it's in an issuer's interest to maximize flexibility, issuers often ask to address items in the definition of Consolidated Net Income rather than in Consolidated EBITDA. In other words, if an issuer is permitted to exclude an extraordinary or unrealized loss from Consolidated Net Income, that will result in a greater capacity to make restricted payments <u>and</u> higher Consolidated EBITDA, which increases its ability to incur debt. High yield investors, on the other hand, sometimes may be comfortable adding an item back in calculating Consolidated EBITDA but may not be comfortable excluding it from Consolidated Net Income and increasing RP capacity.

It's also worth noting that an issuer cannot double count any item. For example, let's assume that the definition of Consolidated Net Income excludes extraordinary gains and losses and that the definition of Consolidated EBITDA includes an add-back for restructuring charges. If an issuer has a restructuring charge that can logically fit under either provision, then it may count it in calculating one or the other — but not both. You can't have your cake and eat it too when it comes to the financial definitions.

* * *

With our discussion of these two crucial financial definitions, we bring our *Concise Guide to High Yield Notes* to a close. We hope this has proven to be a useful introduction to you. If you would like more detail, please reach out to us at LevFin@stblaw.com and we will be happy to provide a copy of *The Definitive Guide to High Yield Covenants*. We look forward to hearing from you as you dig deeper into the high yield covenant package or encounter questions in your transactions.

The Simpson Thacher Team

Simpson
Thacher

Concise Guide to Credit Financing

Introduction

This *Concise Guide to Credit Financing* is meant to be read in conjunction with the foregoing *Concise Guide to High Yield Notes*. We are often asked the differences between covenants in the loan market and those in the bond market, and we thought it would be helpful to address some of the important variances.

Note that we have not tried (and could not) summarize every difference, as every financing (and the terms thereof) is unique, and the market is ever-evolving, so you will find many exceptions to the items we note. But we have tried to provide a flavor of market terms as they currently stand.

This *Concise Guide to Credit Financing* is organized in an order that mirrors the *Concise Guide to High Yield Notes*, and focuses on the following provisions:

- covenants with respect to investments, restricted payments and restricted debt payments;
- the debt and lien covenants;
- covenants governing asset sales;
- change of control; and
- prepayment provisions.

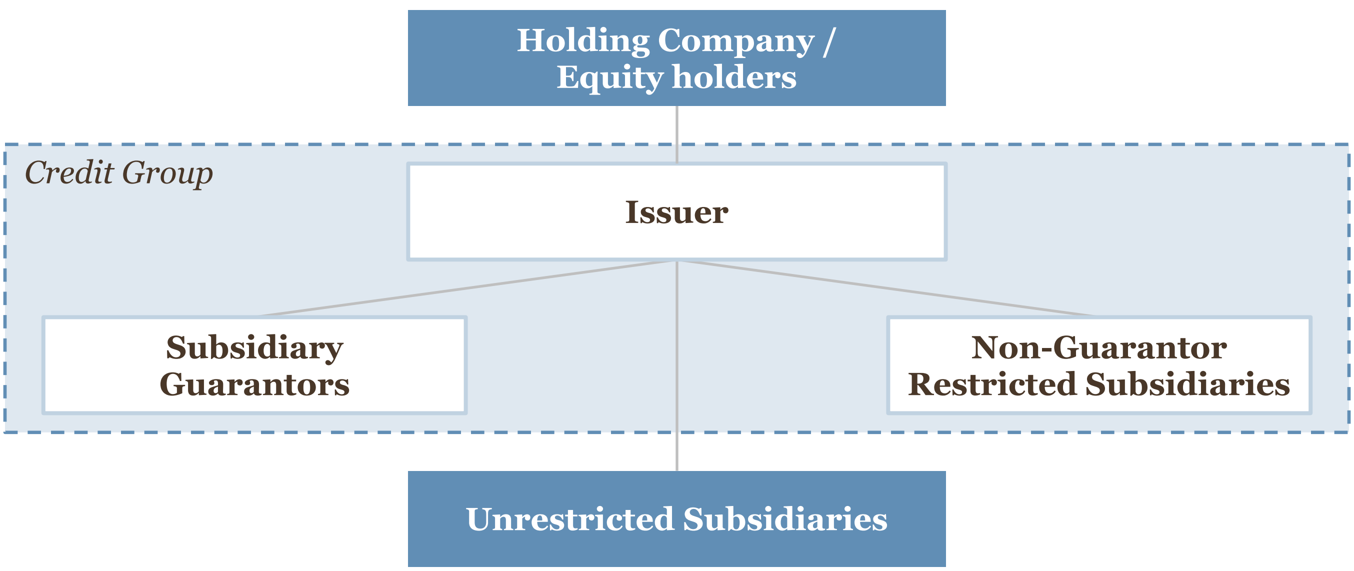
We note that the order of the above provisions is not consistent with the order in which these terms are found in a credit agreement, but instead reflects the most negotiated covenants, followed by a few crucial concepts for discussion.

We also would like to acknowledge that we have focused our discussion on credit agreements that include term loan facilities and cash-flow revolvers, and have not generally addressed asset-based loan ("ABL") facilities. ABL facilities have different prepayment requirements, and different covenant packages, than a typical leveraged loan and are outside the scope of this guide.

Before we embark on a discussion of credit agreements, a few important items to note, where provisions are noteworthy or may differ from high yield indentures.

Restricted and Unrestricted Subsidiaries and Loan Parties

Similar to high yield covenant packages, credit agreement covenants are focused only on governing the actions of the borrower and its "restricted subsidiaries". However, while high yield covenants are flexible in permitting actions between the issuer and its restricted subsidiaries, often allowing unlimited investments between and among the issuer and its restricted subsidiaries regardless of whether those restricted subsidiaries guarantee the high yield debt, credit agreement covenants have historically been more focused on leakage from the borrower and/or guarantors (the "loan parties") to non-guarantor subsidiaries. Thus, while credit agreement covenants will often allow unlimited investments between and among loan parties, there are often limits on investments by loan parties in non-loan party restricted subsidiaries. We do note, though, that as discussed further below in the section titled "Ability to Amend and Covenant Flexibility", there has been some erosion in the traditional covenant protections in credit agreement such that in many deals, the ability for the borrower and restricted subsidiaries to transact (whether or not such restricted subsidiaries are guarantors) more closely mirrors a high yield covenant package.



One other item to note in discussing restricted subsidiaries and unrestricted subsidiaries is that while the use of unrestricted subsidiaries used to be relatively rare and therefore not a lender focus, companies have used unrestricted subsidiaries in recent transactions, such as the JCrew financing, to move assets that were valuable collateral (in JCrew, intellectual property) from loan parties to unrestricted subsidiaries, and therefore outside of the reach of the lender group. As such, there has been increased scrutiny both by lenders and by rating agencies on the ability to move assets to unrestricted subsidiaries and the ability to designate restricted subsidiaries that own valuable assets as unrestricted subsidiaries.

Incurrence vs. Maintenance

High yield covenants in indentures constitute incurrence tests (*i.e.*, covenants are only tested when an issuer or restricted subsidiary wants to take an affirmative action, such as incur debt, pay a dividend or grant a lien), rather than maintenance tests. In term loan B financings, bond-style incurrence tests are typical as well. However, revolver financings and term loan A financings will also include maintenance financial covenants, which are tested at the end of each fiscal quarter and require the borrow to meet certain leverage ratios, interest coverage ratios, etc. Those financial covenants may be fixed at a set ratio for the life of the deal, or may have step downs requiring de-leveraging (or step ups, depending on the financial covenant). Note that where a revolver/term loan A (often referred to as "pro rata" facilities) and a term loan B are contained in the same credit agreement (and where, as is typical, the term loan B does not get the benefit of any financial maintenance covenant), only the pro rata lenders should have a vote to amend or waive the maintenance financial covenant, and pro rata lenders should have the right to accelerate their loans upon an event of default as a result of breach of the financial covenant (with a resulting default in the term loan B if accelerated).

Ability to Amend and Covenant Flexibility

Traditionally, one of the main differences between high yield indentures and credit agreements was that high yield covenants were typically more flexible than credit agreement covenants, based on the notion that high yield covenants were "made to last" over the entire term of the notes, because, among other issues, amending an indenture is a complex process requiring a formal consent solicitation process. Credit agreements, in contrast, traditionally had a more borrower-friendly amendment process, as well as an active administrative agent that can lead the consent process. As a result, credit agreements often had more restrictive covenants than indentures on the theory that the borrower could seek to amend the credit agreement if it wanted to consummate a transaction outside of the ordinary course of business.

However, a shift in the institutions that provide credit agreement loans has changed that calculus. Whereas in the past loans were provided by traditional relationship banks, term loan B lenders are now more typically institutions that approach amendments in the same way as investors that invest in high yield loans. As such, those lenders are both more likely to seek fees or increased pricing for consenting to amendments and more accustomed to flexible covenants. Therefore, credit agreement covenants for term loan Bs (or credit agreements that include term loan Bs) have evolved to more closely mirror the covenant flexibility in high yield indentures.

Intercreditor Arrangements

Bank loans (outside of the investment grade context) are typically secured financings, while high yield debt securities tend to be unsecured. However, companies on occasion tap the market for secured high-yield bonds. When a company incurs both secured bank debt and secured high yield notes, the administrative agent for the lenders and the trustee for the noteholders enter into an intercreditor agreement, which governs the lien priority and rights in respect of the collateral of the two classes of creditors.

In a first lien/second lien structure where the lenders have a first-priority interest in the collateral and the noteholders have a second-priority interest in the collateral, the intercreditor agreement will provide that the administrative agent, as agent for the first lien creditors, controls all matters with respect to enforcement against the collateral. Under such an arrangement, the noteholders can only take action upon the occurrence of an event of default and expiration of a negotiated standstill period during which the administrative agent has not commenced taking, or is not diligently pursuing, action to enforce against the collateral.

In a transaction where the lenders and the noteholders have a pari passu interest in the collateral, because, among other things, as noted above, an administrative agent is more active than a trustee and the voting process for bank lenders is easier than for noteholders, the administrative agent and the bank lenders will typically be the "controlling" class with respect to the exercise of remedies with respect to collateral. Similar to a junior lien structure, the trustee and the noteholders only become the controlling class upon the expiration of a negotiated standstill period during which the administrative agent fails to commence and diligently pursue enforcement actions with respect to the collateral or upon the first lien debt being repaid.

Limitation on Investments, Restricted Payments and Restricted Debt Payments

In a high yield indenture, there is one covenant restricting the issuer's ability to move assets out of the "credit box", and that is a covenant limiting the making of Restricted Payments. In an indenture, "Restricted Payments" is usually defined to include:

- cash dividends and other distributions;
- the redemption or repurchase of the issuer's capital stock;
- the redemption or repurchase of subordinated debt instruments prior to their scheduled maturity; and
- investments that are not listed as "permitted investments".

In contrast, in a credit agreement, the same limitations are typically divided into three separate covenants:

- limitations on making investments;
- limitations on prepaying subordinated (or, in some instances, junior lien or unsecured) debt; and
- limitations on paying dividends and other distributions and redeeming or repurchasing the borrower's capital stock (the items in this clause only are called in this summary "Restricted Payments").

The three covenants allow the lenders and the borrowers to manage, on a more granular level, the treatment of actions that, from a lender's perspective, potentially represent a leakage of cash or diversion of cash from the core business or repayment of senior debt. In a credit agreement that permits unlimited investments, restricted debt payments and Restricted Payments subject to compliance with a specified leverage ratio, the leverage ratio that a borrower has to meet in order to make investments is typically more permissive than the same leverage ratio a borrower must meet to make restricted debt payments or Restricted Payments on the theory that the making of investments is more accretive to the business, and therefore the lenders, than prepaying junior debt or making Restricted Payments.

The "Builder Basket"

That same construct of a hierarchy of the use of cash is also seen in the "Builder Basket" in credit agreements, which is constructed similarly to the "Builder Basket" in indentures. However, in a credit agreement, use of the basket for the making of restricted payments and/or restricted debt payments is often contingent upon pro forma compliance with a specified leverage ratio, but compliance is not typically required for use of the "Builder Basket" for investments.

With respect to the "Builder Basket", there are a few other difference between high yield indentures and credit agreements worthy of note:

- While in indentures the basket typically builds by 50% of cumulative consolidated net income, in credit agreements the borrower is often given the ability to choose whether it wants the basket to build by 50% of cumulative consolidated net income or by retained Excess Cash Flow (as defined below) (*i.e.*, Excess Cash Flow that is not required to be applied toward a mandatory prepayment of the term loans). If the builder basket is to be built by retained Excess Cash Flow, that requires the company to strike a balance between its desire to have Excess Cash Flow be a minimal number so as to avoid a required prepayment and a desire to have Excess Cash Flow be a larger number to increase "Builder Basket" capacity.
- A credit agreement, similar to an indenture, will, in addition to the "Builder Basket," have numerous other negotiated exceptions to the three noted covenants (*e.g.*, fixed dollar baskets, etc.). However, while in an indenture use of some of those negotiated baskets reduces the builder, in a credit agreement the "Builder Basket" is separate and distinct from other potential baskets, and use of other potential baskets has no impact on the builder (which is a factor in the negotiated exceptions).

Limitations on Prepayments of Debt

In the majority of leveraged loan credit agreements, the covenant restricting prepayments of debt will, similar to an indenture, apply only to prepayments of subordinated debt (*i.e.*, debt that is contractually subordinated in right of payment to the loans). However, in a deal where at closing the company has junior debt outstanding (such as second lien loans or unsecured high yield debt), the covenant will often restrict prepayment of such debt as well based on the fact that lenders have extended credit in the capital structure in reliance on such debt being behind them in any downside scenario, and so they expect the company will not prepay such debt ahead of them, unless the company is able to do so utilizing one of the specific exceptions to the prepayment covenant.

Limitation on Indebtedness

Similar to a high yield indenture, a credit agreement will have a covenant restricting the incurrence by the borrower and its restricted subsidiaries of, or the borrower or any of its restricted subsidiaries permitting to exist, indebtedness (with "indebtedness", like an indenture, having a definition that includes more than just debt for borrowed money). And while a credit agreement and an indenture will also each have exceptions to the covenant, permitting the company to incur certain debt, there are a few important distinctions of note between credit agreements and indentures.

Incremental Facilities and Incremental Equivalent Debt

A credit agreement will typically permit the company to increase revolving commitments or the amount of term loan debt under the credit agreement through the use of "incremental" facilities. In a deal that includes a term loan B, incremental facilities are typically permitted in an amount equal to the sum of (i) a fixed dollar amount equal to some percentage of the borrower's EBITDA at closing (although in more aggressive deals this will have an EBITDA grower as well), (ii) 100% of voluntary prepayments of term loans or other pari passu debt plus 100% of commitment reductions in respect of the revolver and (iii) additional pari passu debt so long as after giving effect thereto, first lien leverage does not exceed first lien leverage at closing. Many deals also permit the company to incur junior secured debt subject to a negotiated secured leverage ratio at or outside closing date secured leverage and unsecured debt subject to a negotiated total leverage ratio at or outside closing date total leverage. Note that in some deals there may also be the ability to incur unsecured debt (or junior lien) debt, based on a negotiated interest coverage ratio. We also note that it is typical that credit agreements will include explicit language allowing "stacking" of debt capacity, meaning that in the same transaction the company can incur incremental debt up to the negotiated leverage ratio, and then on top of that incur debt based on the fixed dollar basket and/or the voluntary prepayment amount.

In addition to governing the amount of debt that can be incurred under the incremental, the credit agreement will also provide some guidelines as to the terms of that debt, including requirements that (i) any incremental term debt mature outside of the existing term debt and have a weighted average life to maturity no shorter than the remaining weighted average life to maturity of the existing term debt (subject to any negotiated basket for debt that can mature inside or have a shorter weighted average life to maturity) and (ii) the covenants applicable to such debt be no more favorable to the incremental lenders than the covenants applicable to the existing lenders, with exceptions for covenants that apply after the existing debt matures and other negotiated exceptions. The credit agreement will also provide the conditions to borrowing of the incremental facilities, which will typically require that there be no event of default and a bringdown of representations and warranties (subject in each case to exceptions in the case of incremental term facilities being used to finance an acquisition or investment, in which case the borrower may be permitted to meet a more limited set of conditions).

In a term loan B financing, there will also typically be a "most favored nation" or "MFN" provision, which provides that if the borrower incurs incremental debt that is pari passu with the existing term loan and the pricing for the incremental debt is higher than the pricing for the existing term loan, the existing term loan will get the benefit of that higher pricing. The "MFN" provision will typically have a number of exceptions, notably (i) there is typically a threshold pricing difference allowed between the incremental debt and the existing debt (*i.e.*, if the company has a 50 bps MFN, the existing debt will only get the step-up in pricing to the extent that the incremental facility pricing is more than 50 bps higher than the existing debt), (ii) the MFN may only apply for a certain period of time after closing (*i.e.*, if it has a 1-year sunset, it is only applicable for the first year after closing), (iii) it may not apply to debt maturing significantly outside the maturity of the existing term loan facility, with the logic being that higher pricing may be required for longer-dated debt, (iv) it may have a de minimis carveout where the company can incur debt up to a negotiated amount without having such debt be subject to MFN protection and (v) the MFN provision may only apply to debt incurred in reliance on certain baskets.

Note also that in a term loan financing, putting aside the MFN, the pricing and the fees applicable to an incremental term loan facility are negotiated between the borrower and the lenders providing the incremental facility. However, if the incremental term loan is intended to be fungible with an existing term loan tranche, it is important that the feasibility of doing that fungible tack-on is cleared with tax advisors, as there are rules as to how much original issue discount can be provided for an incremental term loan and have it remain fungible for tax purposes with the existing tranche.

In a revolver-only context, the utilization of the incremental is often called the "accordion", as the sole effect of utilizing the incremental is to increase the size of the facility on the same terms.

The incremental facilities are all facilities that are incurred within the credit agreement - lenders that provide incremental loans or commitments become "lenders" under the credit agreement, and the credit agreement, together with the amendment or supplement under which the incremental was incurred, governs the terms of the incremental debt. Credit agreements will often typically allow the company to utilize their incremental capacity to incur debt outside of the credit agreement instead - and such debt is sometimes called "incremental equivalent debt". Incremental equivalent debt will be subject to some of the same restrictions as incremental facilities, such as the maturity and weighted average life to maturity restrictions, but is somewhat less likely to be subject to MFN provisions, and will not require satisfaction of a "no event of default" condition to funding or a bringdown of representations and warranties. Incremental facilities incurred under the Credit Agreement itself will be limited to pari passu debt - junior lien or unsecured would need to be separately documented.

Note that the "Debt Facility" basket in an indenture, which is capped at a dollar amount or a negotiated leverage level, should be sized to allow any existing credit agreement debt plus any upsizing permitted through the use of the incremental facilities.

Ratio Debt

While in an indenture the "ratio debt" exception to the debt covenant is typically a fixed charge coverage ratio, in a credit agreement the exception will more closely mirror the incremental, with the ability to incur debt subject to meeting specified leverage ratios - and interest coverage ratios, if applicable - which are typically the same as those for the incremental. Thus, the main difference between the incremental and the ratio exception is that while the incremental can typically only be incurred by the borrower, ratio debt can be incurred by the borrower or any of its restricted subsidiaries. As such, and since any debt incurred by a subsidiary that is not a guarantor would be structurally senior to the credit agreement debt, the ratio debt exception often has a negotiated cap on how much debt non-guarantor subsidiaries may incur utilizing such basket.

Limitation on Liens

The lien covenant is a focus in secured credit agreements because it governs the quantum of debt that can be secured on a pari passu basis with the credit agreement loans. In reviewing a credit agreement, the liens covenant will permit the contemplated security for incremental equivalent debt, ratio debt and other obligations intended to be secured, but a few things to note:

Leverage-based incurrence tests

Some credit agreements are drafted such that the lien exception cross-references the debt intended to be secured (*i.e.*, the company can incur liens on collateral specifically to secure incremental equivalent debt or ratio debt). However, other credit agreements are drafted such that there are independent lien permissions so that the company can incur any liens as long as it meets specified first lien/secured leverage ratios, and such permissions are not tied to any specific debt exception. As such, it is important to understand that in the latter case, the company could incur debt pursuant to its general debt basket (which would typically not have any maturity or weighted average life to maturity restrictions) or other permitted debt baskets, and have such debt be secured on a pari passu basis subject solely to meeting a specified leverage test.

Intercreditor Agreements

Credit agreements make it clear that in the case of any incremental equivalent debt, ratio debt or other significant debt for borrowed money that is intended to be secured by the collateral that an intercreditor agreement is required, which governs the interests of competing classes of secured creditors (as described above under “Intercreditor Arrangements”).

Note that historically, the general lien basket - which is typically capped at a negotiated dollar amount, although it may have a builder based on a percentage of EBITDA or assets - was thought of as a “catch-all” basket, meant to include liens that were not permitted by any other lien basket. However, in some deals, borrowers have included provisions providing that use of the general basket to place liens on collateral is permitted so long as the company enters into an intercreditor agreement, with the effect that the general lien basket when used together with the general debt basket, which is typically similarly size, becomes an additional basket allowing for pari passu secured debt.

Limitation on Asset Sales

Unlike a high yield indenture, a credit agreement contains a covenant prohibiting asset sales, subject to negotiated exceptions. Note that the concept of “asset sales” is broader than just sales, and typically includes leases, licenses, transfers and other dispositions. Some of the common permitted exceptions to the covenant include:

- inventory sales,
- sales of obsolete equipment,
- intercompany transfers, which may have limitations on transfers by loan parties to non-loan parties,
- dispositions of accounts receivable in connection with the collection thereof in the ordinary course and not in connection with a financing,
- the making of permitted investments or restricted payments, which are regulated by separate covenants, and
- dispositions of assets to the extent any such asset is exchanged for credit for, or the proceeds of such sale are applied to the purchase price of, similar or replacement assets.

Credit agreements will also have a general dispositions basket, which may be subject to a fixed dollar cap or tied to a percentage of EBITDA or assets. In some deals, the general basket allows unlimited dispositions subject to:

- the sale being for fair market value,
- if the sale is in excess of a threshold amount, the company receiving a minimum percentage of cash consideration, with what qualifies as cash, and the carveouts thereto - including a basket for items "designated" as cash even though they are not - subject to negotiation,
- a no event of default condition, and
- the proceeds of such sale being subject to the mandatory prepayment requirements of the credit agreement as discussed under "Mandatory Prepayments" below.

Change of Control

In contrast to an indenture, where a change of control of the issuer triggers a mandatory offer to repurchase the notes at 101% of par, plus accrued and unpaid interest, credit agreements typically provide that the occurrence of a change of control is an immediate event of default. As such, lenders holding more than 50% of the loans (and/or commitments) can waive such change of control or can choose to accelerate the loans as a result of such event of default. The fact that a change of control would trigger an event of default, coupled with the fact that credit agreements typically do not have significant call protection, means that in most transactions where a change of control is triggered, the borrower will choose to voluntarily repay the loans.

Definition of Change of Control

Whereas a change of control in an indenture is often triggered by the sale of "all or substantially all" of the assets of the issuer to another person or the issuer adopting a plan of liquidation, in a credit agreement those two concepts are often addressed in a separate covenant restricting the borrower from making "fundamental changes", such as merging, consolidating, liquidating or selling all or substantially all of its assets.

As such, while there are different permutations, a credit agreement might provide that a change of control occurs if:

- prior to an IPO, permitted holders cease to own at least 50% of the voting stock of the borrower;
- post-IPO, a person or group (other than permitted holders) obtains more than a negotiated percentage of the voting stock of the borrower; and
- to the extent there is a holdco sitting on top of the borrower and pledging the borrower's equity, a requirement that the holdco maintain ownership of 100% of the voting stock of the borrower.

Additionally, given that change of control provisions may differ among debt documents, credit agreements may provide that a change of control is triggered if a change of control occurs under any outstanding high yield indenture or junior lien debt document. That provision is intended to protect bank lenders and ensure that they are included in any negotiations occurring when a change of control transaction is contemplated.

Note that in some credit agreements there is also a change of control triggered if the majority of the board of directors of the borrower fail to be "continuing directors", *i.e.*, either the closing date directors or directors whose election was approved by a majority of the closing date directors (or their approved replacements). There are some legal considerations to discuss with counsel as to this prong of the change of control.

Optional Prepayments

Unlike high yield indentures, where prepayments are often restricted for a period of time, credit agreement debt is normally pre-payable at any time, subject to prior notice to the lenders. However, a typical term loan B facility will include a "soft call" provision. That provision will provide that if, within some specified time period post closing (typically six months, but may be as long as 24 months), the term loan is prepaid with the proceeds of lower priced term debt, or the facility is amended to lower pricing, the lenders will receive a prepayment premium, which is typically equal to 1% of the amount prepaid or repriced.

Mandatory Prepayments

One of the distinguishing characteristics of a credit agreement is that, unlike high yield indentures, there are mandatory prepayment provisions. Those prepayments typically only affect term loans, and there is no requirement to prepay revolving loans.

Excess Cash Flow

Credit agreements will customarily include an excess cash flow sweep, whereby the company must make an annual prepayment from a percentage of "Excess Cash Flow", with the prepayment percentage typically starting at 50-75%, and decreasing if the company satisfies specified leverage ratios.

"Excess Cash Flow" for any fiscal year is typically built by:

- the sum of:
    - consolidated net income,
    - non-cash charges deducted in determining consolidated net income to normalize for actual cash flow of the company, and
    - decreases in net working capital, as such decreases represent a source of funds (either an increase in short-term liabilities as the company, for example, stretches timing of payment of its accounts payable or a decrease in short-term assets as, for example, customers pay accounts receivable quickly),

- minus:
    - non-cash gains included in determining consolidated net income to normalize for actual cash flow of the company,
    - increases in net working capital, as such increases represent a use of funds (a decrease in short-term liabilities as, for example, short-term debt is paid is off or an increase in short-term assets as, for example, customers delay payments), and

- other permitted uses of cash, such as capital expenditures and prepayments of long-term debt (other than the credit facilities).

Further additions and deductions in the Excess Cash Flow definition are highly negotiated, as companies are incentivized to minimize required prepayments - although as noted above in the discussion of the "Builder Basket", in cases where retained Excess Cash Flow (*i.e.*, Excess Cash Flow not required to prepay the term loans) is the foundation of the "Builder Basket", that incentive is tempered.

Note that in addition to the Excess Cash Flow definition containing deductions for certain uses of cash, the prepayment provision itself provides that the amount of the prepayment is reduced by certain items, including any voluntary prepayments of the term loans and any prepayments of the revolving facility accompanied by a permanent reduction in the revolving facility.

The fact that there are two different reduction mechanisms for Excess Cash Flow - one in the definition itself before giving effect to the prepayment percentage, and one in the prepayment provision after giving effect to the prepayment percentage - is worth noting. The effect is that any deductions after giving effect to the prepayment percentage are given 100% credit (*i.e.*, dollar-for-dollar credit), and therefore are more desirable from a borrower perspective.

Asset Sales

In a secured credit agreement, lenders are looking to the company's assets as their collateral. Thus, it is customary that credit agreements require that upon the sale of assets outside of the ordinary course, the company prepay term loans in an amount equal to 100% of the net cash proceeds of the asset sale. While the baseline is 100% prepayment from the net cash proceeds of non-ordinary course sales, there are a number of items subject to negotiation:

- The threshold for triggering the mandatory prepayment - Neither lenders nor borrowers want the company to have to prepay term loans as a result of de minimis sale proceeds. As a result, asset sale prepayment provisions provide that the company must only prepay loans to the extent that the proceeds exceed a threshold amount (and in some deals, only in an amount in excess of that threshold amount, even if doing so would again result in a de minimis prepayment),
- The sales that trigger the prepayment requirement - in some deals only a sale using the general asset sale basket will result in a mandatory prepayment, while in other deals it will also be triggered by other asset sales, such as sale leaseback transactions,
- The prepayment percentage - In some deals, the company can lower the required prepayment percentage from 100% upon the achievement of negotiated leverage ratios,
- Reinvestment rights - Credit agreements will typically provide that in lieu of prepaying term loans, the company can reinvest the money in assets useful to the business. The time period the company has to reinvest is subject to negotiation but is typically 12-18 months, with an additional six months to consummate the reinvestment if the company commits to reinvest within the initial time period.

Note also that because the credit agreement will often allow for other pari passu secured debt, which may similarly have asset sale prepayment requirements, the credit agreement will typically allow that the required prepayment amount may be allocated ratably to pari passu secured debt.

*   *   *

We hope that this *Concise Guide to Credit Financing* has provided a useful overview of credit agreements, and some of their unique terms and provisions. Please do not hesitate to reach out to us at LevFin@stblaw.com if you have any questions.

The Simpson Thacher Team

Simpson Thacher