High Yield Indentures: Typical Covenants

**A Lexis Practice Advisor® Practice Note by
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This note provides an introductory overview of typical high yield covenants in indentures, along with examples of how these covenants are commonly constructed and typical exceptions and carve-outs. Note that every covenant package has its quirks and this note focuses only on typical provisions. However, as the high yield market conditions continue to evolve, market conditions as well as industries may change what is and what is not typical in this space.

For additional information on high yield covenants, see High Yield vs. Investment Grade Covenants Chart, Market Trends 2018/19: High Yield Debt Offerings and Top 10 Practice Tips: High Yield Debt Offerings. For a general overview of debt securities, see Corporate Debt Securities in U.S. Capital Markets.

Overview of High Yield Covenants

Unlike bank loans, which are traditionally held by a relatively small number of lenders, high yield bonds are usually widely held and high yield investors do not expect to be approached to consent to amend any of the terms of the bonds, except in special circumstances (i.e., in connection with a significant merger or acquisition). Moreover, amending a high yield indenture requires a formal consent solicitation process that may be costly and time consuming for the issuer, and is therefore a process that issuers generally seek to avoid. As such, high yield covenants should provide the issuer with flexibility to operate its business and grow over the life of the bonds (which may have a maturity of five to ten years), without having to amend any of the terms of the bonds, while also providing protection for high yield investors against an issuer being able to overextend itself or unwisely use its cash. In other words, high yield covenants should protect the investors' ability to be paid principal and interest on the bonds while preserving the issuer's ability to run its business without undue restrictions. It is key to keep the need to balance these two objectives in mind as you draft and negotiate covenant package for a high yield indenture.

Restricted vs. Unrestricted Subsidiaries

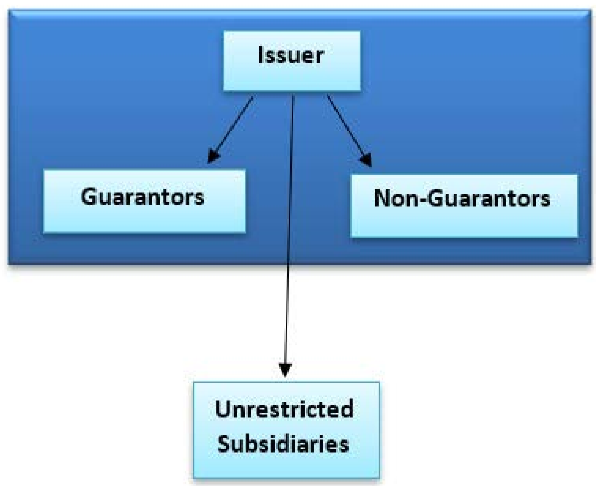
Restricted subsidiaries are subsidiaries of the issuer which are subject to the covenants and the net income and earnings before interest, tax, depreciation and amortization (EBITDA) that they generate are included in calculating certain key ratios and baskets contained in the restricted payments, debt, and lien covenants discussed below. Restricted subsidiaries typically include all of the subsidiaries of the issuer (including guarantors of the notes), other than any subsidiaries that the issuer affirmatively designates as an unrestricted subsidiary. Often, for business reasons, issuers designate one or more of their subsidiaries as unrestricted subsidiaries. Most indentures provide the issuer with the ability to designate any of its subsidiaries as an unrestricted subsidiary through board resolution and the delivery of an officer's certificate to the trustee for the notes. For example, an issuer may want to consummate a project finance transaction that is non-recourse to it. As a result, it may create unrestricted subsidiaries to consummate such a transaction because unrestricted subsidiaries are outside of the reach of the high yield covenants. However, it should be noted that designating a subsidiary as unrestricted has the following negative effects:

- The issuer generally is prohibited from counting that subsidiary's net income and EBITDA, unless the issuer actually receives cash from the unrestricted subsidiary.
- Most interactions between the issuer and its restricted subsidiaries, on the one hand, and an unrestricted subsidiary, on the other hand, must be treated as if they were transactions with an unrelated third party and comply with the related party transactions covenants, which can be burdensome.

All of the entities in the dark-blue credit box shown below are the entities that a high-yield covenant package regulates. The key point to remember is that non-guarantor subsidiaries of the issuer are still restricted subsidiaries, unless they are designated as unrestricted subsidiaries.

The credit box

The credit box



In most cases, other than ratio debt and the merger covenant described below, the covenants treat guarantors and non-guarantors in the same way under the indenture and the distinctions are mainly between restricted subsidiaries and unrestricted subsidiaries.

Incurrence vs. Maintenance

High yield covenants are generally incurrence-based tests rather than maintenance tests. In other words, high yield covenants are typically tested only when an issuer or a restricted subsidiary actually wants to do something, like pay a dividend, incur debt, or grant a lien. Most high yield covenants do not require an issuer to meet quarterly maintenance covenants that you often see in credit agreements. It happens from time to time but in very limited, highly distressed circumstances.

Typical High Yield Covenants

While each high yield covenant package is distinct and often tailored to the specific industry the issuer operates in, the main covenants are summarized below.

Limitations on Restricted Payments

The restricted payments (RP) covenant is all about regulating the amount of cash and other assets that are allowed to flow out of the credit box (shown above). Generally, RPs are defined to include:

1. Cash dividends and other distributions
2. The redemption or repurchase of the issuer's capital stock
3. The redemption or repurchase of subordinated debt obligations prior to their scheduled maturity
4. Restricted investments, which are investments that are not listed in the definition of permitted investments

This covenant reflects the tension among (1) the desire of holders of notes to preserve the cash flow of the issuer for debt service, (2) the desire of the issuer to make investments and other restricted payments, and (3) the desire of equity holders to receive dividends and other distributions in respect of their equity investment. As the RP covenant is trying to balance these interests in a way that will ensure that everyone can get what they need over the life of the notes, it is often the most negotiated covenant.

The typical RP covenant has three components:

1. **The builder basket.** The builder basket seeks to encourage the issuer to grow over time by allowing a portion of the issuer's net income to be used for RPs. As the company grows, so too does its capacity to make RPs.

   (a) High yield issuers often successfully negotiate a starter amount, which kicks-off the builder basket at either (1) a negotiated dollar amount from the date the notes are issued or (2) a look-back date that specifies that the basket started growing at a date prior to the date the notes were issued (a look-back date is usually the first date the issuer issued debt of the same seniority as the notes being issued). While this has become fairly common, it is worthwhile to have a solid business argument for the necessity of a starter amount as investors have been increasingly focused on such amounts.

   (b) Typically, before an issuer can access its RP builder basket, it must (1) not be in default under the indenture and (2) be able to incur at least $1.00 of debt under its fixed charge coverage ratio discussed further under the debt covenant.

      (i) A fixed charge coverage ratio is typically the ratio of EBITDA for the last four fiscal quarters to fixed charges, which includes interest expense, dividends on disqualified stock and dividends on preferred stock of restricted subsidiaries.

      (ii) While some deals, particularly in the telecom space, use a leverage ratio instead, the fixed charge coverage ratio is the most common metric in high yield covenant packages.

2. **Exceptions.** Several negotiated exceptions that the issuer can use even if it has not been able to build capacity under the RP builder basket above. The most common exceptions are:

   (a) Exchanges of capital stock, disqualified stock, or subordinated obligations of the issuer for capital stock of the issuer

   (b) Refinancing of subordinated obligations with subordinated obligations

   (c) Redemptions of subordinated obligations pursuant to asset sale or change of control covenants in other debt instruments, subject to certain conditions

   (d) Redemptions of management equity, capped at a negotiated level

   (e) For dividend paying public companies, a negotiated basket for periodic dividends

   (f) A general RP basket, capped at a negotiated dollar amount

   (g) In some deals, an unlimited basket for restricted payments, so long as the issuer meets a negotiated dollar threshold

3. **A list of permitted investments.** Some of these are ordinary course investments and others which are specifically negotiated to fit the issuer's business. The key permitted investments often include:

   (a) Intercompany investments in the issuer or a restricted subsidiary

   (b) Investments in a person in a similar business that becomes a restricted subsidiary or merges with and into the issuer or an existing restricted subsidiary as a result of the investment

   (c) nvestments in cash and cash equivalents

   (d) Guarantees issued in accordance with the debt covenant

   (e) Investments in joint ventures and unrestricted subsidiaries, capped at a negotiated dollar amount

   (f) A general permitted investments basket, capped at a negotiated dollar amount

   (g) n some deals, particularly in the E&P space, an unlimited basket for permitted business investments

As the RP builder basket is usually based on a portion of consolidated net income, the definition of such term is usually negotiated and tailored to the issuer's business. In addition, note that if a company wants to make an investment, it can use any of the permitted investment baskets and any of the applicable restricted payments baskets.

Limitation on Indebtedness

The debt covenant regulates how much debt the issuer can incur and the type of debt that it can incur. High yield debt covenants have two main components:

1. **The ability to incur ratio debt**. An issuer and its subsidiary guarantors are typically prohibited from incurring debt unless a specific financial ratio (usually a fixed charge coverage ratio described above) is met (usually at least a 2 to 1 ratio, after giving effect to the incurrence of debt, but some companies, particularly in the E&P space have a 2.25 to 1 or 2.50 to 1 ratio).

2. **Negotiated baskets and exceptions.** Investors recognize that in order to continue to operate and grow the business, an issuer will need to be able to incur certain types of debt, even if it cannot incur ratio debt described above. As such, there are always exceptions to the debt covenant, the most common are:

   (a) Debt under credit facilities (note that the definition of credit facility often includes indentures as well as traditional bank credit facilities), capped at a negotiated dollar amount

   (b) Debt existing on the date of the indenture

   (c) Capital lease obligations or purchase money debt, capped at a negotiated dollar amount

   (d) 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 improves)

   (e) Foreign subsidiary debt, capped at a negotiated dollar amount

   (f) A general debt basket, capped at a negotiated dollar amount

   (g) Certain intercompany debt

   (h) Guarantees by the issuer or restricted subsidiaries of certain debt permitted under the debt covenant

Almost every high yield indenture includes a debt reclassification concept that permits the issuer to divide, classify and even retroactively reclassify its incurrence of debt among the different debt basket exceptions.

The definition of indebtedness is often negotiated and typically includes items that do not strike you as debt (i.e., net hedging obligations and the obligations of other persons that the issuer or its restricted subsidiaries guarantee or secure). It is important to ensure that the definition of indebtedness captures all of the items you want the debt covenant to apply to. In addition, it is worth mentioning two things about baskets generally in a high yield indenture:

1. For purposes of the debt covenant and other covenants in a high yield indenture, issuers can use multiple baskets to incur debt or take other actions.

2. Many of the baskets are capped at the greater of a dollar amount and a grower based on an asset or EBITDA metric. For example, if a company grows and increases its asset base, it is permitted to incur more debt because it has the assets to service such debt.

Limitation on Liens

Hand-in-hand with the debt covenant is the lien covenant. The lien covenant regulates how much debt the issuer and its restricted subsidiaries can secure and what assets it can use as collateral. It protects the investors' position in the capital structure by regulating the incurrence of secured debt that may be effectively senior to or pari passu with the high yield bonds and ensuring that the high yield bonds will have a senior priority lien on collateral that secures any junior debt. The lien covenant contains an exception for permitted liens, which is a negotiated list of exceptions to the lien covenant. The list of permitted liens is often long and tailored to the business of the issuer, however, there are a handful of important, and therefore common, exceptions, which include:

1. Liens incurred to secure all or a portion of the debt incurred under a credit facilities debt basket referred to above

2. Liens incurred to secure all or a portion of the capital lease obligations or purchase money debt basket referred to above

3. Liens incurred to secure all or a portion of the debt existing on the date of the indenture

4. A general liens basket, capped at a negotiated dollar amount

5. In some deals, an unlimited basket for liens subject to a certain leverage ratio

In an unsecured notes indenture, the lien covenant will not prohibit the issuer from incurring secured debt other than the permitted liens, rather it will provide that if the issuer and its restricted subsidiaries wish to encumber assets to secure other debt outside of the permitted liens exceptions, they can do so, so long as the notes are equally and ratably secured with such other debt. However, very often, the credit agreement in the capital structure may prohibit using such equal and ratable clause.

Limitations on Asset Sales

High yield indentures do not usually place strict limitations on asset sales. Subject to certain exceptions, the asset sale covenant typically permits the issuer or its restricted subsidiaries to use the proceeds either to prepay certain debt or reinvest in the business (within a certain period of time). If the proceeds are not used pursuant to the guidelines, the issuer will be required to offer to repurchase the high yield bonds from bondholders at par.

An asset sale is typically broadly defined to include any kind of transfer, sale or disposition of assets, including issuances or sales of capital stock of subsidiaries. To avoid capturing unnecessary items, the definition will exclude, among other things: (1) intercompany sales, (2) inventory sales, (3) sales of obsolete equipment, (4) sales that are regulated by the merger covenant (see below) or constitute a change of control (see below), and (5) the making of RPs (see above). In addition, there is always a de minimis basket that excludes any asset sale less than a negotiated dollar threshold.

A common requirement in the asset sale covenant is that (1) the issuer receives fair market value for the assets and (2) that a specified percentage of the consideration for the asset sales (usually 75%) is in the form of cash or cash equivalents. Additionally, most covenant packages include a designated non-cash consideration basket, which allows the issuer to designate as cash, non-cash consideration, up to a certain negotiated dollar threshold over the life of the bonds.

Because this covenant is so permissive, practitioners do not tend to spend much time negotiating it.

Limitations on Affiliate Transactions

The limitations on affiliate transactions covenant limits the issuer's and its restricted subsidiaries' 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 definition of affiliate is typically based on the traditional Securities Exchange Commission (SEC) definition, which includes persons that control, are controlled by or are under common control with the issuer.

Most high yield indentures include a negotiated de minimis transaction threshold under which the issuer need not worry about the limitations on affiliate transactions covenant. Beyond this, the covenant stipulates thresholds above which a certain type of approval is required in order to allow the affiliate transaction. For example, it is common to see indentures which require that affiliate transactions above a certain threshold be approved by a majority of the board of directors of the issuer, including by a majority of the independent directors on the board with no interest in the transaction.

Additionally, there are some common exceptions to this covenant, which include:

- The making of restricted payments and most permitted investments (see above)
- 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
- In financial sponsor deals, payment of management fees to the sponsor and engagement of the sponsor's affiliates for services
- Loans to employees in the ordinary course

While this covenant usually does not generate significant controversy, issuers' management need to be mindful of its existence when planning to execute affiliate transactions that may seem like ordinary course transactions to them.

Reporting

The reporting covenant governs the information the issuer must provide to its investors on a regular basis in order to support trading in the securities and to monitor the performance of the issuer. The aim of the reporting covenant is to ensure that, regardless of the type of issuer, noteholders are provided with:

- 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
- Quarterly conference calls with management

While the intent of this covenant is to ensure that all noteholders generally receive the same type of information, it is important to provide issuers that are private companies or public company issuers without SEC reporting obligations with flexibility. For example, these issuers often need more time to prepare their annual or quarterly reports than the SEC rules allow and as a result, such issuers are often given more time in practice to prepare their first couple of reports until they get into standard cadence vis-à-vis preparing such reports.

Merger Covenant

The merger covenant is principally designed to prevent a business combination in which the surviving obligor of the bonds is not financially healthy. The covenant prohibits the issuer and its subsidiary guarantors from merging with or consolidating into another entity, or transferring all or substantially all its assets to another person, unless certain conditions are satisfied. The typical conditions imposed on an issuer are:

- The absence of a default
- The ability of the issuer to incur at least $1.00 of additional debt under its fixed charge coverage ratio after the transaction, or, an improvement in the fixed charge coverage ratio after the transaction
- The continued existence of the issuer, or if the issuer has been substituted, that the new issuer be a U.S. entity
- The continued effectiveness of the guarantees of the notes
- The delivery by the issuer to the trustee of an officers' certificate and an opinion of counsel certifying that the transaction was consummated in accordance with its terms and the conditions contained in the indenture have been satisfied

The conditions placed on the subsidiary guarantors usually mirror the five conditions listed above, with the exception of the $1.00 of debt test described above.

One of the most interesting (or frustrating) aspects of the merger covenant and the change of control put (described below) 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 tender to analyze the qualitative (such as the quality of the assets) 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, issuers should raise the issue with their counsel if there is any doubt about whether the business being sold may be all or substantially all of their assets.

Just because an issuer is not in breach of its merger covenant, does not mean it is in compliance with its indenture. Remember to always check how the merger covenant interacts with the asset sale covenant (described above) and the change of control put (described below). As described above, usually sales of all or substantially all of an issuers assets in compliance with the merger covenant is an exception to the asset sale covenant. However, it is common for issuers to trip the change of control put even when they have met the conditions under its merger covenant.

Change of Control Put

Typically, the change of control put requires that the issuer offer to repurchase the high yield bonds from bondholders at a price equal to 101% if a change of control occurs. Note that this is a put right for a holder and not a redemption right for the company and unlike may credit agreements, a change of control is not an event of default. How change of control is defined is where the negotiation comes in. A change of control is typically defined to occur when: (1) a person or group obtains ownership of 50% or more of the voting stock of the issuer, (2) a merger or consolidation transaction occurs in which the equity holders of the issuer before the transaction do not represent the majority of equity holders of the surviving entity, (3) the issuer sells all or substantially all of its assets, or (4) the issuer adopts a plan of liquidation.

High yield deals with double trigger concept whereby you need to have a change of control accompanied by a ratings downgrade from rating agencies in order to trigger a put right are quite common. However, over the past 12-18 months, there has been increasing resistance to this concept by investors and as a result, more and more deals revert to the traditional single trigger formulation described above.

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David Azarkh is a Partner in Simpson Thacher's New York office and a member of the Firm's Corporate Department. David's primary area of concentration is capital markets, an area in which the Firm has a preeminent U.S. and international presence.

David regularly represents underwriters, corporate clients and private equity sponsors in securities offerings ranging from high yield and investment grade debt offerings, leveraged buyouts, initial public offerings and other capital markets transactions. He also assists companies with compliance, reporting and establishing corporate governance programs.

In 2016, David served as a Contributing Editor of the inaugural edition of "Getting the Deal Through: High-Yield Debt." The publication provides advice and insight into the global high yield market, with chapters covering a range of international jurisdictions. David co-authored the opening segment titled "Global Overview," and the "United States" chapter discussing recent activity in the high yield market.