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Five Points For Issuers To Consider When Preparing Covenant Package For High-Yield Notes Offering

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High-yield covenants usually, among other restrictions, restrict an issuer's ability to incur debt, make restricted payments (restricted payments can include making certain dividends, equity repurchases, investments and payments on subordinated debt) and sell assets. These covenants can contain exceptions that a) generally permit particular types of transactions, b) permit transactions in any amount so long as a ratio test is satisfied (for example, the ability to incur debt so long as the interest coverage ratio would be at least 2.0 to 1.0) or c) provide baskets permitting transactions up to an amount not tied to a ratio test.

Baskets permitting transactions up to an amount not tied to a ratio test often provide that such transactions are permitted up to the greater of a fixed dollar amount and a "grower" amount based on assets or EBITDA.

In connection with preparing a covenant package for a high-yield note offering, there is naturally a focus on whether to include the latest concepts from recent note offerings that might be considered more aggressive. Whether these newer provisions are worthwhile to include for a particular issuer largely depends on the potential marketing impact of each provision. However, there are also a number of more settled areas where adjustments can offer issuers meaningful flexibility while being more readily accepted from a marketing perspective.

Five examples of this flexibility are:

1. Derivative Carve-Outs

Issuers might desire to enter into derivative transactions that, because they are for hedging purposes rather than speculative purposes, are not as concerning for potential noteholders. One example is an issuer entering into an interest rate swap to effectively convert an issuer's floating rate debt to fixed rate debt. Another common example is an issuer entering into hedge and warrant transactions in connection with a convertible notes offering.

- **Concern:** As these derivative transactions involve obligations owed to or by the issuer, may be voluntarily terminated, and involve payments when settling, multiple covenants could be implicated. Even if a

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derivative transaction can fit within general basket capacity at a given point in time, it can be difficult to track the impact on typical baskets given that the value of the derivatives upon termination are uncertain while they remain open.

- **How some issuers have addressed:** Some issuers have included language in the debt, lien, restricted payment and asset sale covenants, as needed, to expressly permit derivative transactions. Such carve-outs are often unlimited so long as the derivatives are non-speculative or tied to debt convertible to common stock.

- **Sample language:** An example of language seen that limits derivative carve-outs to those that are non-speculative in nature provides that the agreements are permitted so long as they "(x) are designed primarily to protect against fluctuations in foreign currency exchange rates or interest rates (whether fluctuations of fixed to floating rate interest or floating to fixed rate interest) and (y) do not increase the indebtedness of the obligor outstanding at any time other than as a result of fluctuations in foreign currency exchange rates or interest rates or by reason of fees, indemnities and compensation payable thereunder."

2. Credit Facility Basket (Mandatory Allocation)

High-yield covenant packages often include a credit facility basket as an exception to the debt and lien covenants. The credit facility basket is normally sized to permit the issuer's existing term and revolving loans, sometimes with room to grow to match the issuer's incremental debt capacity.

- **Concern:** When an issuer has multiple series of notes outstanding, it is possible that some debt initially allocated to the credit facilities basket in existing notes has been refinanced so that such debt has now been incurred under a ratio test and no longer hits the credit facility basket. The increased availability under the credit facility basket is valuable because using this basket does not require compliance with a ratio and "credit facility" is usually defined broadly enough to include most types of debt. In the context of issuing an additional series of notes, an issuer often looks to preserve any debt capacity it has under its outstanding series of notes.

- **How some issuers have addressed:** When a portion of an issuer's credit facility debt is permitted as ratio debt under an existing series of notes, some issuers have successfully carved out such debt from the credit facility basket mandatory allocation in subsequent series of notes. This normally leads to treating such debt as being incurred under the standard clause that permits debt existing as of the issue date. This adjustment is intended to put the issuer in the same spot with respect to debt capacity under both the new series of notes and the existing series.

- **Another thought:** Because revolving loans typically are not deemed to be incurred until such loan is drawn on, issuers generally "reserve" the full amount of revolver capacity against the credit facility basket. This is intended to permit an issuer to be able to draw on its revolver up to the maximum amount without needing to perform any calculations.

3. EBITDA Calculations (Pro Forma Effect)

In connection with various transactions, including acquisitions, dispositions and the incurrence of debt, high-yield covenant packages frequently include detailed provisions on how to give pro forma effect.

- **Concern:** Indentures might use EBITDA for baskets in addition to using EBITDA in the context of ratio incurrence tests. If applicable definitions only provide for pro forma effect to be given when calculating ratios, then an issuer may be left without the benefit of an acquisition target's EBITDA and have to rely solely the issuer's proven EBITDA for such baskets. Only the most restrictive covenant packages do not give pro forma effect to an acquisition target's EBITDA when calculating ratios and giving pro forma effect to related debt.

- **How some issuers have addressed:** Issuers have sought to obtain the benefits of pro forma EBITDA for baskets in addition to the ratio tests by ensuring that the pro forma provisions for the interest coverage ratio apply to EBITDA when it is a standalone concept.

- **Sample language:** Rather than recreating all of the pro forma effect language that is likely already included in other definitions (and would be too long to recreate here), language like the following is sometimes added to a definition of consolidated EBITDA: "For purposes of this definition, when used in a basket, ratio or test, Consolidated EBITDA shall be calculated after giving effect on a pro forma basis for the applicable period of such calculation in a manner consistent with the definition of Consolidated Interest Coverage Ratio."

4. Fixed Dollar Baskets (Matching the Grower)

Many baskets include both a fixed dollar component and a grower component. Such baskets provide that the applicable covenant exception is available up to the greater of the fixed dollar amount and the grower amount. The fixed dollar amount is typically sized to match the amount of the grower component at launch.

- **Concern:** If issuing a new series of notes, issuers may be "stuck" with the fixed dollar baskets from the prior series and not gain the benefits of growth since the prior series of notes were issued. While updating the basket floors may not be relevant in a situation where an issuer is continuing to grow and can therefore always rely on the grower, the fixed dollar basket provides protection against shrinking assets or EBITDA, particularly if there is a significant disposition.

- **How some issuers have addressed:** Although it presents as an increase from existing offerings, some issuers have successfully updated the fixed dollar amounts to match the grower at the launch of a new issuance. These increases are generally easier to push through than other increases to basket capacity.

- **Another thought:** If a series of notes is being issued in connection with an acquisition, some issuers have also sought that pro forma effect be given to the acquisition when sizing the fixed dollar baskets.

5. Financial Covenant Calculations

As high-yield covenant packages contain both carve-outs that are based on ratios and baskets that are available regardless of ratio compliance, this can sometimes lead to questions on whether both types of carve-outs can be used at the same time for particularly large transactions.

- **Concern:** Without express language addressing the matter, it might be difficult to conclude that an issuer may incur the full amount of debt permitted by ratio tests and simultaneously incur additional debt under baskets that are not dependent on such tests. This leads to a result that can seem anomalous in that the issuer may be prohibited from completing one large transaction but could do a transaction up to the maximum amount permitted by the ratio tests and then do an unrelated transaction the following day that utilizes the additional baskets.

- **How some issuers have addressed:** Although it has historically been more common to include this concept in credit facilities than notes, it is increasingly likely to see high-yield note offerings include provisions providing that the full amount of debt permitted pursuant to ratio tests may be incurred without giving effect to the use of any baskets that are not dependent on a ratio test and that are used simultaneously with such ratio test.