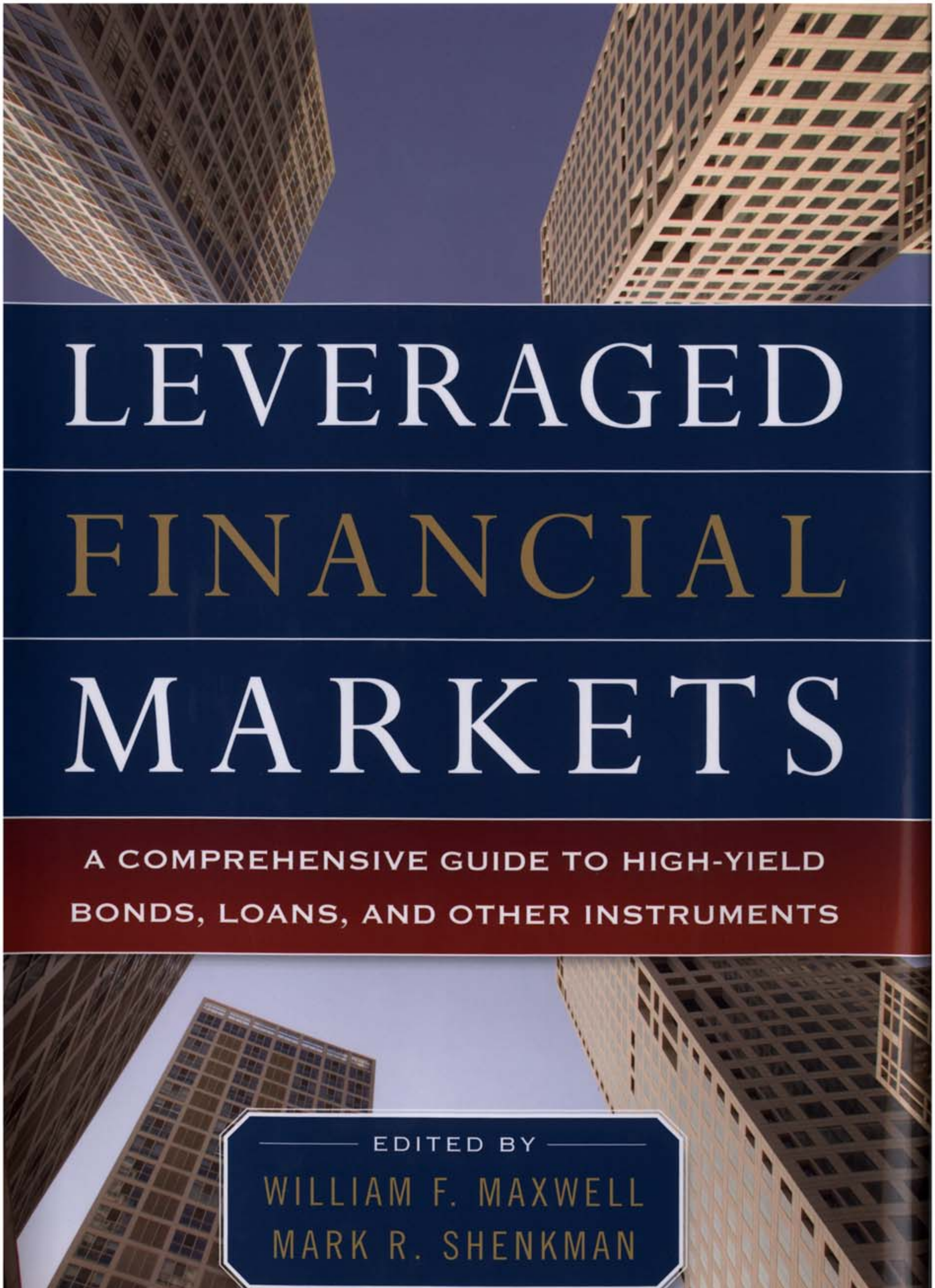
LEVERAGED
FINANCIAL
MARKETS
A COMPREHENSIVE GUIDE TO HIGH-YIELD
BONDS, LOANS, AND OTHER INSTRUMENTS
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BOND INDENTURES AND BOND CHARACTERISTICS

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High-yield bonds are issued pursuant to a document called a trust indenture. The indenture is a contract between the issuer of the bonds and a banking institution that acts as trustee for the benefit of the holders of the bonds from time to time. High-yield bonds are most commonly sold to investors by the issuer through investment banks, or underwriters, in an offering that is registered under the Securities Act of 1933 or in a private placement (often referred to as a Rule 144A offering) that is exempt from the registration requirements of the Securities Act.

In the indenture, the issuer subjects itself to restrictions on its future ability to carry on certain activities, such as issuing additional indebtedness and paying dividends. These restrictions are called covenants, and although they reside in a contract signed by the trustee, they are there for the benefit of the bondholders. Since the terms of these covenants have to be included in the offering document that is distributed to investors to solicit their interest, they must be established in advance and are therefore typically negotiated between the issuer and its counsel on the one hand and the underwriters and their counsel on the other. In this chapter we describe some of the common characteristics of high-yield bonds in the U.S. market and also focus on some of the more standard covenants and related terms of U.S. high-yield indentures.

Common Characteristics

Almost all high-yield bonds are issued with a “bullet” maturity, which means that they have a single maturity date for the entire principal amount of the bonds. It is uncommon for bonds to have any early mandatory redemption terms (with the exception of some “put” provisions related to the occurrence of specified events, discussed below) or any sinking fund feature. Although high-yield bonds increasingly are issued with floating rates of interest, it is still more common for the bonds to be issued with a fixed coupon.

The decision concerning which type is appropriate in a particular situation will depend in part on the needs of the particular issuer but also on the judgment of the underwriter as to which will lead to the most successful offering. This in part depends on which type of institutional investors is most likely to participate in a transaction. If the bonds have a fixed coupon, interest is paid semiannually. Floating-rate bonds usually have quarterly interest payment dates. In either case, interest payment dates are typically the first or fifteenth of a month by market convention.

In addition to “cash-pay” high-yield bonds, some issuers will issue “zero coupon” bonds, where no cash interest payments are made for a period of time (not longer than five years, for U.S. tax reasons), but instead the original principal amount of the bonds accretes semiannually at the implied interest rate, such that at maturity the repayment obligation of the issuer is substantially in excess of the initial gross proceeds received by the issuer. Related to zero coupon bonds are “pay-inkind” securities, where the semiannual payments of interest are made not in cash but in additional securities of the same class having a principal amount equal to the accumulated six months of interest. During the initial term that the high-yield bonds are outstanding, typically approximating the halfway point of the scheduled term of the bonds, the issuer is precluded from redeeming the bonds at its option. From a bondholder's perspective, this is an important provision. Often referred to as the "no call" period, the prohibition on optional redemptions during this period means that the bondholder can "lock in" the yield for this period and is not at risk that it will have to reinvest redemption proceeds too soon after making the initial investment decision. Beginning at the end of the no-call period, the bonds can be redeemed (or "called") at a premium that thereafter declines on each anniversary date until there is no premium in the last year or two of the life of the bonds.

One significant exception to the no-call period, which is typically effective for the initial three years of the term of the bonds, was created to allow an issuer to redeem a portion (typically 35%) of the outstanding bonds, but only to the extent that it has raised cash proceeds from the issuance of common equity. From the bondholders' perspective, they are willing to give up some of their yield protection so long as the issuer's stockholders' equity is increased. The redemption price is usually par plus the coupon (e.g., 110% for a 10% bond). This provision is often referred to as the "equity clawback." This provision was originally limited to the issuance of equity in the public markets by a private company, since bondholders not only wanted an increase in equity but also a public company valuation (which would improve the valuation methodology on the bonds). However, that limitation has all but disappeared, particularly with the substantial involvement of private equity firms in the high-yield market to finance acquisitions. High-yield bonds are typically denominated as senior notes or senior subordinated notes. Occasionally you will see a more junior subordinated security, which is often either a discount security or convertible into common stock of the issuer. It is important in any high-yield offering to understand the relative contractual and structural priorities of the potential claimants against the issuer and its subsidiaries. When bonds are "senior subordinated," this means that the bonds are contractually subordinated by their terms to other specified classes of indebtedness.

The other type of subordination, called "structural subordination," cannot generally be discerned from the title of the bonds, but rather only by an understanding of the corporate structure of the issuer and its affiliates and subsidiaries. Structural subordination refers to the fact that the liabilities of subsidiaries of the issuer, which often include claims in addition to those of debt holders (e.g., trade creditors and preferred stock of subsidiaries), are superior to the claims of the bondholders to the extent of the value of the assets of such subsidiaries, even if the bonds are senior notes. This is because in any bankruptcy or liquidation involving the issuer and its subsidiaries, bondholders who do not have any direct claims against the subsidiaries (e.g., through a subsidiary guarantee) are entirely dependent on the recovery by (or on behalf of) the issuer of any value of the issuer's common equity claim against the subsidiaries.

Of course, that common equity claim is junior to those of the debt, trade, and preferred stakeholders of the subsidiary. Thus the bondholders' claim against the issuer is said to be structurally subordinated to those against the subsidiaries. This can be particularly meaningful if the issuer is a shell holding company and most of the consolidated assets are held in the subsidiaries. If the bonds are contractually subordinated, then pursuant to the subordination provisions of the indenture, the issuer will be contractually prohibited from making payments of principal or interest to bondholders under specified circumstances. In short, if there is a payment default with respect to senior indebtedness, the issuer is automatically prohibited from making payments on the bonds for as long as the default continues. If there are other defaults under senior indebtedness that entitle the holders to accelerate their debt, then the senior debt holders have the right to instruct the issuer not to make any payments with respect to the subordinated bonds. Such instructions are typically valid for no more than 179 days, at which point the issuer is entitled to resume making payments on the bonds unless the holders of the senior indebtedness have accelerated their indebtedness. Notwithstanding this contractual arrangement, the nonpayment on the bonds by the issuer during the 179-day period constitutes a default under the indenture, and depending on the specific provisions of the indenture, the bondholders may have certain rights to accelerate payment of the bonds as a result of such nonpayment. However, the bondholders' right to actually receive payment from the issuer will continue to be restricted by these very same contractual subordination provisions.

Nearly all Rule 144A high-yield offerings contain contractual obligations on the part of the issuer to ensure that the bonds are freely tradable under the securities laws within specified time periods following the closing of the Rule 144A offering. This can be achieved with the passage of time under Rule 144, which generally provides that after six or twelve months, nonaffiliates of the issuer can freely trade securities issued by the issuer in a private placement. Other methods to achieve this liquidity are to require the issuer to subsequently offer to the bondholders in an SEC-registered offering bonds that are identical to the restricted bonds acquired in the initial 144A distribution or to require the issuer to file with the SEC a "resale" registration statement that allows the investors to freely resell their bonds into the public markets. The concept here is that in exchange for their willingness to buy the bonds without the benefit of a registration statement so that the issuer can obtain its financing on an expedited basis, the bondholders insist that the issuer agree to these obligations. The sole remedy available to the bondholders for the issuer's noncompliance with these obligations is an increase in the interest rate on the bonds for so long as the default continues. The failure to comply with these covenants does not constitute a default under the indenture.

Covenants

High-yield covenants are crafted to proscribe specified actions by the issuer on a case-by-case basis. As a result, they are often referred to as "incurrence-based" provisions, as opposed to provisions that require the issuer to maintain compliance with specified terms on an ongoing basis, which are referred to as "maintenance" covenants. Maintenance covenants are intended to measure the ongoing health of the issuer and to give "early warning signals" to the lenders if the business of the issuer is deteriorating. In such an event, the lead, or agent, bank may spearhead negotiations with the borrower to amend the applicable covenant to avoid an imminent default and possibly to provide new or incremental economic or contractual benefits to the bank group in order to obtain the requisite consent to the amendment. In many cases this process can be completed quickly and efficiently.

By contrast, an issuer's series of high-yield bonds might be held by 50 or more institutional investors, none of which has the predesignated role of lead or agent. If the high-yield indenture contained maintenance covenants, an issuer would be hard-pressed to get the holders organized on short notice to consider and agree to a revised maintenance covenant based on the issuer's then present financial condition. As a result, a covenant default would be hard to avoid, and the consequences of public disclosure and possible cross-defaults could be disastrous.

With incurrence-based covenants, an issuer need not worry about falling out of compliance based on events beyond its control. Rather, it need only test compliance with the covenant if it proactively intends to take an action, such as to borrow more money, to pay a dividend, or to sell assets. And if it finds itself in a situation in which it desires to solicit consents to amendments to the terms of the covenants in order to take an action, it can do so in an orderly process where the result, even if unfortunate, is not disastrous if it fails to obtain the requisite consent of bondholders.

The three primary objectives of the covenants from the bondholders' perspective are to (1) prevent the issuer from undertaking new obligations that could divert the issuer's cash flows toward competing claimants, rather than being available to meet its preexisting cash obligations, including debt service on the bonds themselves, (2) prevent the issuer from favoring another class of creditors over the bondholders by preserving the relative priorities of claimants, and (3) prevent the issuer from disposing of assets for less than equivalent value such that the remaining assets are not sufficient to discharge its remaining obligations, including debt service on the bonds. In crafting these covenants, a balance must be struck between achieving these objectives and giving the issuer the flexibility to grow and execute its business plan (which is presumably in the bondholders' interest) during the term of the bonds, which might be as long as 10 years.

Most bond indentures will contain the same list of covenants that will all start with the same basic proscription and then include a list of exceptions, some of which will be customary from deal to deal and the rest of which will be specifically negotiated for each deal. Many regular participants in the market will agree that some terms are "absolutely market" and then disagree about the rest. In fact, the concept of "market" evolves over time and depends on the type of issuer, the then strength of the high-yield market, the prospective rating on the bonds, and other factors. Certainly the active participation of private equity funds in the high-yield market over the past decade has had a substantial impact on the form of the covenants, particularly the emergence of significant exceptions and carve-outs from the basic covenants. The marketing spin on the issuer's business strategy will also justify certain departures from market: for example, a start-up company may need to borrow substantial amounts after the bonds are issued, so the concept of leveraging new equity (permitting the incurrence of new amounts of debt based on the amounts of the equity raised after the bonds are issued) was created; similarly, a company with the stated strategy of pursuing joint ventures needs plenty of room to make investments.

One last general observation: the definitions matter. Much of the substance in understanding the covenants is actually in the definitions. They are often complex, and all the participants, but particularly the issuer's internal finance staff, must familiarize themselves with their nuances.

Restricted Subsidiaries versus Unrestricted Subsidiaries

It goes without saying that the issuer itself will be governed by the covenants. The other entities that will also be governed by the covenants will be certain of the issuer's subsidiaries, which are referred to as restricted subsidiaries. Generally, a subsidiary is any entity (corporate, partnership, etc.) in which a majority of the voting power is held by the issuer. Thus, the borrowing and other activities of a 50%-owned joint venture are not governed by the covenants. Because the activities of restricted subsidiaries are governed by the terms of the covenants to the same extent as those of the issuer, generally an issuer is free to conduct any business transactions (e.g., intercompany borrowings and investments) with subsidiaries that are restricted subsidiaries.

The activities of unrestricted subsidiaries are not governed by the covenants. In fact, the covenants treat unrestricted subsidiaries as if they were unrelated third parties, and accordingly the issuer has to evaluate every transaction with an unrestricted subsidiary for its compliance with the covenants. Thus, while cash generally is permitted to flow freely among the issuer and its restricted subsidiaries, this is not the case with unrestricted subsidiaries.

Whether a subsidiary is restricted or unrestricted is ultimately up to the issuer, although for the reason stated at the end of the preceding paragraph, most subsidiaries are restricted, even though this requires that they must abide by the indenture covenants. So why would an issuer elect to treat a subsidiary as unrestricted? An issuer might conclude that a start-up subsidiary, especially one that is engaged in a business line that represents a new venture for the issuer and is incurring net losses in its early start-up phase, might adversely affect the calculation of the issuer's covenant net income if it is part of the restricted group; at the same time, if it were not governed by the covenants and could incur substantial amounts of debt to finance its growth, it might thrive. Whatever the reason, a bondholder would generally be willing to allow an issuer to designate a subsidiary as unrestricted (which would leave it exempt from the covenants and therefore potentially of no residual value to the bondholders), if this designation is made at the time of the issuance of the bonds. Bondholders are also usually willing to permit issuers to designate a subsidiary as unrestricted after a bond has been issued, so long as at the time of designation the subsidiary has only nominal assets or the issuer is forced at the time of the designation to tap into one of its covenant baskets that it might have otherwise used for some other purpose, such as paying out a dividend to equity holders.

If the issuer chooses to bring a previously unrestricted subsidiary back into the restricted group (it may elect to do this because the subsidiary is now generating positive net income and it wants to be allowed by the covenants to freely transfer cash or other assets to and from such subsidiary), it may do so under the covenants only if, after giving pro forma effect on a consolidated basis to that subsidiary's then outstanding levels of indebtedness and cash flow, the issuer would have the capacity to incur additional indebtedness according to the indebtedness covenant. In this way the bondholders can have some assurance that the issuer is not bringing into the restricted group an entity with too much debt that may need to be serviced by cash flow from the issuer or other restricted subsidiaries.

Change of Control

The change of control provisions of the indenture are designed to allow the bondholder, upon the occurrence of certain events, to reevaluate the investment in the issuer represented by the bonds. If in light of the occurrence of such an event, the bondholder for any reason elects to exit the investment (and does not want to sell on the open market because the then current market price of the bonds is depressed), the issuer is required to buy the bonds at a purchase price of 101% of the principal amount of the bonds. This is commonly referred to as a change of control "put." Also common, especially in private equity deals, the indenture also includes a change of control redemption right on the part of the issuer. The market will accept this concept, even if it infringes on the no-call period, because the redemption premium is typically quite expensive for the issuer.

If the issuer is not at the time of bond issuance a public company, a change of control is often deemed to occur if a designated group of controlling shareholders (the so-called "permitted holders") fails to continue to own at any time a majority of the outstanding voting stock of the issuer. The permitted holders will usually include the majority shareholder, if there is such a single shareholder at the time issuance, or a group of shareholders that at the time of the issuance of the bonds collectively owns a majority of the voting stock of the issuer. The theory is that the bondholders have made an investment decision based upon an evaluation of the merits of shareholder control at the time of the investment, and if such controlling shareholders fail to continue to hold that controlling position (which in a private company context is assumed to be a majority), then the bondholders should be entitled to reevaluate their investment in the bonds.

Another event that is considered a change of control is somewhat similar to the first, but it applies in a public company context (whether the issuer was public at the time of issuance or becomes so thereafter). Here the permitted holders are entitled to fall below 50% and in fact could fall all the way to zero in terms of voting percentage ownership, without triggering a change of control. A change of control under this prong occurs only if persons other than the permitted holders acquire (typically) 35% or more of the voting power of the issuer and the permitted holders own a smaller percentage and the permitted holders do not have the right, by contract or otherwise, to elect or designate a majority of the members of the board of directors. The 35% level is used as a proxy for a level of voting power in a public company that is considered to be de facto controlling, even if not in actuality. Many private equity deals are negotiated so that this event does not happen unless the voting power of third parties exceeds 50%.

Other events that can trigger a change of control would be a successful proxy fight for control of the board, without regard to who holds shareholder voting power, as well as a liquidation of the issuer. A final common event that would constitute a change of control is an acquisition of a publicly held high-yield issuer by merger with another publicly held company, such that the public shareholders of the acquirer are the majority shareholders of the survivor, even if after the merger the voting stock of surviving entity in the merger is widely held. Many bondholders believe that a transaction of such magnitude is a significant enough event in the life of a high-yield issuer to allow the bondholders to reevaluate the investment, even if no single shareholder is technically in "control."

Restricted Payments

The restricted payment covenant is focused on limiting what the issuer is allowed to do with cash or other assets that it may have generated from operations or otherwise. The general principle is that the bondholders want to trap the cash and other assets of the issuer and its restricted subsidiaries and allow them to exit the credit group only under limited circumstances. Restricted payments include dividends on capital stock, the purchase of capital stock, the early purchase or redemption of debt that is subordinated to the bonds, and the making of investments.

With respect to dividends, the payment of a dividend in an issuer's own stock (other than certain types of stock), is freely permitted. The type of stock that would not be permitted (so-called "disqualified stock") is stock that has terms that are debtlike—they may have mandatory redemption provisions or otherwise be subject to maturity prior to the maturity of the bonds.

With respect to the purchase of capital stock, restricted payments include not only the purchase of the issuer's own capital stock but also, typically, the purchase of capital stock of a restricted subsidiary to the extent it is held by an affiliate of the issuer. Investing in or purchasing capital stock of restricted subsidiaries is generally viewed as a permitted investment (that is, not subject to this covenant). However, if such capital stock is held by an affiliate, the benefits for creditors such as bondholders obtained by the issuer's acquisition of a greater percentage of the restricted subsidiary may be offset to the extent that a controlling person is perceived to be cashing out of at least a part of his or her investment. The term investment has a broad definition to include any debt or equity investment in another person. Guarantees of another person's debt are also typically considered to be investments in that person. Capital expenditures, or acquisitions of assets, are not investments and are not restricted by this covenant.

Certain types of investments are excluded from the definition of restricted payments. These permitted investments are generally ordinary course types of investments, such as accounts receivable (which are in effect investments in the customer), and advances to employees (which are investments in the workers). However, permitted investments also include any investment that the issuer makes in a restricted subsidiary or in a person that as a result of the investment will become a restricted subsidiary. These are important provisions that permit the free flow of cash and assets between an issuer and its restricted subsidiaries and are the quid pro quo for subjecting the restricted subsidiaries to the terms of the indenture.

This is perhaps the most significant consequence of having distinctions between restricted subsidiaries and unrestricted subsidiaries (cash is not permitted to flow freely from the issuer to an unrestricted subsidiary). Occasionally one will also see significant exceptions to the restricted payments covenant buried in the definition of permitted investments. For instance the definition might include joint venture investments up to a specified dollar amount.

Once an issuer has determined that the action it proposes to take involves a restricted payment, it must test it against the covenant itself. In the first instance, before an issuer can make a restricted payment, it must be in a position to incur indebtedness under its general debt incurrence test that is discussed below. The theory of this requirement is that if the issuer is not healthy enough to meet the minimum threshold for incurring debt (i.e., it doesn't have sufficient cash flow vis-à-vis interest expense), then it should not be permitted to make any restricted payments for the benefit of junior security holders.

The amount that can be paid out by the issuer as a restricted payment at any time is often referred to as the "dividend basket" or the "restricted payment basket." This basket will be increased, or built up, by the factors described below and will be reduced, or depleted, by the amount of restricted payments actually made over time.

The general test for building up the restricted payment basket is based on the cumulative consolidated net income of the issuer and restricted subsidiaries subsequent to the issue date of the bonds. To the extent that the issuer has recognized, over the entire time period since the issuance of the bonds, positive net income, it is allowed to take 50% of that amount and pay it out as dividends or make other restricted payments. Net income is essentially based upon generally accepted accounting principles (GAAP) and is not a cash calculation. On the other hand, if the issuer has, since the original issuance date of the bonds, recognized a cumulative net loss, then 100% of the loss counts against the issuer in determining dividend-paying capacity. This negative amount will become relevant if the issuer has otherwise developed some dividend-paying capacity pursuant to other methods of increasing the dividend basket.

In calculating consolidated net income, the net income of an unrestricted subsidiary (even if wholly owned by the issuer) or of any "investee" company (i.e., less than majority-controlled) can be included by the issuer only to the extent that cash is actually received by the issuer or one of its restricted subsidiaries from such unrestricted subsidiary or investee company. This limitation recognizes that the issuer probably does not, typically because of limitations in other contracts, have full access to the net income of these entities, and therefore it should not be entitled to a full credit for the net income—only for the cash it receives. Similarly, to the extent that a restricted subsidiary is subject to restrictions (contractual or otherwise) on its ability to pay dividends to the issuer, the issuer does not get credit for the net income of that restricted subsidiary, except to the extent that the issuer receives (or could have received) cash from that restricted subsidiary.

The second important way that an issuer can develop or increase its dividend basket is through the issuance of equity. If the issuer raises equity proceeds after the issuance of the bonds, other than proceeds from the issuance of disqualified stock, then it is entitled to receive a dollar-for-dollar credit to its dividend-paying capacity. Bondholders are willing to give credit to an issuer for this purpose to the extent that the issuer has raised the corresponding amount of cash through the issuance of junior securities. The issuer can also develop or increase its dividend basket through the conversion of its outstanding debt into equity or through the realization of proceeds from the divestment or repayments of certain investments it has made since the issuance of the bonds.

Many indentures include some common exceptions to the restricted payments covenant that entitle the issuer to make specified types of payments even if it is unable to incur additional indebtedness under the debt incurrence test or it has been unable to generate sufficient dividend-paying capacity through net income and equity proceeds to make these payments. The first exception allows the issuer to make a restricted payment with the proceeds of the issuance of capital stock (so long as it is not an issuance of disqualified stock), provided that the making of the restricted payment must occur substantially concurrently with the issuance of the new stock. Note, as discussed above, that while ordinarily the issuance of capital stock would increase an issuer's dividend-paying capacity, the issuer may not be able to access that capacity if it is unable to pass the debt incurrence test (the first condition described above under the covenant). In that event, this exception allows the issuer to use equity proceeds to effect a restricted payment when it is not otherwise allowed to make a restricted payment, although of course it is not entitled to double-count the dollar amount of the proceeds of this equity offering by adding it to the dividend basket.

The second common exception allows the issuer to acquire subordinated debt with the proceeds of other subordinated debt. Generally the bondholder is indifferent to the exchange of one subordinated security for another, and allowing the issuer to do this may help the issuer to avoid defaults or other financial crises under the debt to be replaced. There are usually several customized exceptions for each issuer based upon its particular capital structure (e.g., if there is an existing class of preferred stock, you may see an exception to allow the issuer to pay dividends on the preferred stock). You may also see exceptions designed to permit the issuer to effect its ongoing business strategy (e.g., if it is the stated intent of the issuer to make certain investments, then this covenant should allow the issuer to make these investments, usually up to certain specified dollar levels).

Indebtedness

The limitation on the incurrence of indebtedness is designed to protect the bondholders from the issuance by the issuer of additional debt unless the issuer has the demonstrated capacity (usually tested based upon a comparison of cash flow to interest expense) to service all its debt, including the proposed new debt. This test is generally known as the "coverage" or "debt incurrence" test, and the debt permitted to be incurred is generally referred to as "coverage debt." If the issuer does not have the demonstrated capacity, then it may not incur any additional debt except to the extent that it can take advantage of certain specified exceptions to the debt incurrence test that are available to the issuer without regard to its debt-servicing capacity. This kind of debt is often referred to as "permitted debt."

This is a limitation on the incurrence of indebtedness; once incurred, the issuer is permitted to leave that debt outstanding notwithstanding any subsequent deterioration in debt-servicing capacity. Indebtedness as defined in most high-yield indentures generally includes indebtedness for money borrowed, lease obligations that would appear on the balance sheet of the issuer, reimbursement obligations with respect to standby letters of credit (i.e., excluding trade letters of credit that are obtained in the ordinary course of the issuer's business), obligations with respect to disqualified stock, preferred stock of subsidiaries, guarantees issued by the issuer that are in respect of indebtedness of other persons, and security arrangements undertaken by the issuer to secure indebtedness of other persons. Indebtedness does not include obligations to pay interest or dividends. Note that guarantees are indebtedness (they are also investments in the person whose obligation is guaranteed).

The basic debt incurrence test allows the issuer to incur “coverage debt” if the issuer—on a trailing 12-month basis and on a pro forma basis assuming the proposed indebtedness had been incurred at the beginning of such 12-month period—has enough cash flow (typically based on earnings before interest expense, taxes, depreciation and amortization, or EBITDA) in relation to its cash and noncash interest expense (typically a minimum ratio of 2 to 1). An occasional alternative to the interest coverage test is a leverage test, which evaluates the relationship of the issuer’s consolidated debt to its trailing 12-month EBITDA on a pro forma basis for the incurrence of the indebtedness.

Regardless of whether a proposed borrowing would be considered coverage debt or permitted debt, it is important to the issuer and bondholders alike whether the covenant allows restricted subsidiaries, as well as or instead of, the issuer to incur the debt. For instance, if the bonds are senior notes, the bondholders would prefer that most, if not all, incremental debt be issued by the issuer itself and not by subsidiaries. If subsidiaries were allowed to issue the incremental debt, substantial amounts of indebtedness could potentially be issued at a structurally superior level, and thus the notes, which were marketed as senior notes, might become structurally subordinated to substantial amounts of debt. The same considerations may not exist in a senior subordinated note offering, where the bondholders have already agreed to contractual subordination and may therefore care somewhat less about the potential amounts of structurally superior debt.

In calculating an issuer’s interest coverage ratio to determine eligibility at any time to issue coverage debt, the indenture definitions look back over the preceding four fiscal quarters and include on a pro forma basis the incurrence of the proposed indebtedness and any other incurrences or repayments of indebtedness as if these incurrences and repayments had occurred at the beginning of the period. Similarly the definitions give the issuer pro forma credit for investments that have had the effect of adding EBITDA during the course of the preceding four fiscal quarters and require the issuer to subtract EBITDA that may have been attributable to a restricted subsidiary or line of business that may have been disposed of during the course of the year.

If an issuer does not qualify at the time to issue coverage debt, it would then review the various categories of permitted debt to determine whether the proposed borrowing can fit in one of those exceptions. Almost every high-yield debt covenant contains an exception for the issuer to incur bank debt. The exception may be constructed around the issuer’s borrowing base (inventory and accounts receivables), or it may be limited to a specified dollar amount. Another important category of permitted debt is intercompany debt between the issuer and its restricted subsidiaries, so long as it is issued to the issuer or a restricted subsidiary and also remains with that person (or with another member of the same group). If the debt is transferred outside the group to a third party, it no longer qualifies for this exception and is deemed to be incurred again at the time of transfer. In that event, the issuer would need to identify another provision of the covenant that would allow it to incur this debt.

Every indenture needs to permit the issuer to refinance any of its indebtedness, whether it was outstanding at the time of the indenture or was issued after the debt was incurred, in order to limit the possibility of a default at the maturity of the other indebtedness. In issuing any refinancing debt, the issuer may not increase the principal amount (except to the extent needed to pay related costs, e.g., accrued interest, premium, and other retirement costs), the issuer may not shorten the average life of the debt that is being refinanced, and the issuer may not refinance subordinated debt with senior debt.

Almost every high-yield debt covenant contains a general basket— generally referred to as the "debt basket"—that permits the issuer, and sometimes its restricted subsidiaries, to issue a specified dollar amount of indebtedness, again without regard to whether the issuer has the necessary interest coverage ratio that would permit it to issue coverage debt. This catchall basket is intended to protect the issuer in the case of an "emergency," where it may need to incur debt and cannot satisfy the debt incurrence test and cannot identify any other specific exception. In addition to these customary categories of permitted debt, most indentures will include additional exceptions that would apply to a specific issuer. For instance, an issuer that historically has acquired capital assets with purchase money indebtedness or through capital lease transactions would typically negotiate for an additional exception that would permit such transactions in the future.

In connection with any individual incurrence of indebtedness, the issuer does not need to identify a single provision that will permit the entire amount of this indebtedness. For instance, the issuer could incur a portion of the indebtedness based upon the credit agreement exception and could also incur a portion of the indebtedness with respect to its general basket. In senior subordinated note indentures, the issuer is not allowed to incur any debt that is contractually subordinated to any indebtedness unless the debt to be incurred is also senior subordinated (i.e., equal to the high-yield bonds) or is subordinated to the bonds. In other words, the issuer cannot have any subordinated debt that is senior to these senior subordinated bonds.

Restrictions on Distributions from Restricted Subsidiaries

The general thrust of the covenant that places restriction on distributions from restricted subsidiaries, which is not heavily negotiated, is to prevent the issuer and its restricted subsidiaries from agreeing to any contractual limitations on the ability of the subsidiaries to send cash and other assets, whether in the form of dividends or loans or other property transfers, to the issuer. Obviously, to the extent that such contractual limitations were in place, the issuer would have substantially less ability to service its own debt, including the bonds. Generally the exceptions to this proscription include those that are in effect on the date the bonds are issued (and presumably are disclosed to prospective investors) and encumbrances that are contained in refinancing agreements and which are not more restrictive than those in the debt agreement to be refinanced. Given the adverse consequences of these limitations to the issuer's cash flow and therefore to the issuer's creditors, to the extent that a subsidiary is allowed by this covenant to contractually restrict itself from paying dividends to the issuer, the definition of consolidated net income typically excludes some or all of the income of a subsidiary from the issuer's calculation of consolidated net income.

Sales of Assets

The limitation on the sales of assets covenant does not prohibit an issuer from effecting asset sales. Although the covenant requires sales of assets to be made at fair value and that a large percentage (between 70% and 90%) of the consideration be received in cash, the main purpose of the covenant is to limit the uses of proceeds in the event that the issuer does sell assets. From the bondholders' perspective, when an issuer sells an asset, it has removed potential income-producing assets from the consolidated group. As a result the bondholder expects the issuer within some reasonable period of time to either pay off debt (thereby reducing the debt service burden on the assets that remain) or else invest in new assets (typically only assets that are related to the issuer's core business) that in theory will also be producing income. This covenant is one of the easiest for an issuer to comply with because the issuer has substantial discretion over a period that often extends for a year whether to retire other indebtedness or to make capital expenditures (or even certain investments) with the proceeds of the asset sale. To the extent that the issuer does neither within this period, the covenant requires the issuer to make an offer to the bondholders to purchase their bonds at par to the extent of the proceeds. To the extent that any proceeds remain after all bonds tendered in such an offer are in fact purchased, they are usually available to the issuer to use however it sees fit, including, if the issuer has built up any dividend-paying capacity, making restricted payments.

This covenant is designed to capture proceeds only from asset dispositions that are outside the ordinary course of business, and then only to the extent that they exceed some negotiated floor amount that is deemed immaterial. Issuers may request special treatment or other exceptions from the application of this covenant for dispositions that are reasonably foreseeable by the issuer at the time the bonds are issued. Since most issuers usually intend to or are required by their bank lenders to repay debt with the proceeds of asset sales anyway, issuers often decide not to spend much time negotiating significant carve-outs to this covenant.

Transactions with Affiliates

The covenant relating to transactions with affiliates is designed to prevent the issuer from circumventing the restricted payment covenant by disguising a dividend-like transaction in the form of a business transaction. Accordingly, the covenant requires the issuer to ensure that any transaction with an affiliate is conducted on terms that are similar to those that would be obtained with unrelated third parties and, depending upon the dollar amount involved in the transaction, that such terms are approved by the majority of disinterested directors and/or that such terms are determined to be fair to the issuer in the opinion of an independent valuation firm.

This covenant takes on added significance when the issuer is a private company that is controlled by one shareholder or a small group of shareholders. An issuer that is publicly held is likely to be concerned about the fairness of affiliate transactions for reasons of corporate law and usually does not object to any significant degree to the terms of this covenant. A private company issuer is likely to request carve-outs for fees paid to financial sponsors, for example, and for other transactions that are reasonably foreseeable. These exceptions are typically kept to a minimum, since the effect of creating an exception is to permit a transaction that may have terms that are not fair to the issuer.

A common exception recognizes that if an issuer is permitted by the restricted payments covenant to pay a dividend that depletes its dividend basket, thereby sending assets completely out of the consolidated group, the investor should be relatively indifferent if, rather than electing to pay the dividend, the issuer elects to enter into some other kind of transaction (e.g., an investment) with an affiliate. Another common exception permits transactions between the issuer and its restricted subsidiaries. Also permitted are transactions with entities that are technically affiliates of the issuer because they are controlled by the issuer (e.g., 45% voting stake), but otherwise should be viewed as a third party (e.g., the remaining 55% voting stake is held broadly by persons that are not affiliates of the issuer). The covenant does not typically restrict the issuer from issuing capital stock to affiliates (other than disqualified stock). Among other common carve-outs are provisions that permit transactions relating to contracts in effect at the time of the issuance of the bonds (and which should probably be described in the offering document), as well as relating to renewals or extensions of the contracts that have terms not less favorable to the issuer than those in the original contract.

Liens/Sale-Leasebacks

The lien covenant has primary importance in an indenture for senior notes. In a senior subordinated note offering, the holders typically insist only on the "antilayering protection" arising from the issuer's agreement not to grant any liens to secure other subordinated debt. Conversely, the holders of senior notes, in an effort to remain as senior as possible with respect to the assets of the issuer, restrict the issuer from incurring liens (which includes security interests, mortgages, and similar contractual or legal encumbrances) on its assets except for limited permitted exceptions, or unless the issuer is willing to simultaneously grant an equal lien for the benefit of the bondholders.

These exceptions usually appear in a definition of permitted liens, which usually includes a long laundry list of ordinary course liens (e.g., warehousemen's liens). In addition to those, however, and the ones that are typically the most important to the issuer, are those that deal with purchase money financings, financings under one or more of the categories of permitted debt, preexisting or acquired liens, and refinancings of debt that is already secured. An important but subtle point is to determine whether the assets that are permitted to be subject to the liens should be limited (e.g., for purchase money debt, only the asset acquired should be permitted to secure purchase money debt, but for permitted bank debt, any assets of the issuer or its restricted subsidiaries are typically permitted collateral).

Another covenant that would typically be found only in a senior note offering and is considered a corollary to the limitation on liens covenant is a covenant limiting the issuer's ability to enter into saleleaseback transactions. A sale-leaseback transaction, in which the issuer sells an asset and immediately leases it back, is economically very similar to a secured financing, since the issuer will receive sale proceeds (similar to loan proceeds) and will make rental payments over the life of the lease (similar to loan repayments). Thus, this covenant generally permits an issuer to enter into sale-leaseback transactions as long as the issuer has the ability to incur the related indebtedness represented by the lease obligation and would be able to incur the lien on the property securing the lease. However, since the asset has been sold and is therefore not part of the issuer's consolidated assets subsequent to the sale (unlike a secured financing), this covenant contains the added requirement that the issuer treat the sale proceeds as it would in connection with any other asset sale.

Mergers and Consolidations

The merger covenant is designed to ensure that the successor or survivor in any major transaction involving the issuer, including the transferee of substantially all the assets of the issuer, assumes the obligations with respect to the bonds. As for substantive requirements in connection with such transactions, the covenant requires that the issuer on a pro forma basis be able to incur indebtedness under the debt incurrence test. This substantive requirement is often the subject of some negotiation because it is not readily clear to many issuers why this particular measurement is relevant in determining whether a merger is one that makes financial and business sense from the perspective of the bondholders.

Nonetheless, the high-yield market has historically insisted that the issuer be financially healthy (as measured by the debt incurrence test) before it is entitled to engage in any significant merger transactions. As a general rule, bondholders reasonably expect some improvement in the issuer's creditworthiness over the life of the bonds, as measured by interest coverage, and it could substantially and adversely affect the secondary trading value of bonds if the indenture permitted a reasonably healthy and deleveraged issuer to releverage itself as part of a merger transaction.

SEC Reporting

In the infancy of the high-yield market, many issuers were able to avoid regular reporting to bondholders and certainly often were able to avoid regular SEC reporting. Since most high-yield note deals are ultimately held by fewer than 300 holders, issuers would automatically be relieved, pursuant to the Securities Exchange Act of 1934, of any SEC reporting requirements beginning with respect to the fiscal year following the year in which the registration statement for the bonds became effective. It is now almost universally true in high-yield indentures that the issuer is required to make regular SEC reports (and to post such information on the issuer's own Web site) to ensure the steady flow of readily accessible information for current holders and prospective holders. (Note that this is one of the few affirmative covenants in a high-yield indenture and one that does require some maintenance efforts on the part of the issuer.) It is important in transactions involving foreign issuers to review the indenture language to understand whether they are bound to report on a basis similar to U.S. domestic issuers or whether they are entitled to follow the more relaxed SEC rules for foreign private issuers. This is usually a matter of some negotiation prior to the issuance of the bonds. Because of the uptick in the number of financial restatements by SECreporting companies in the past few years, which causes delays in the filing of regular reports with the SEC and therefore defaults under this covenant in high-yield indentures, issuers are likely to obtain some relief in the language of this covenant (or in the language in the related default provision) to avoid a hair-trigger event of default and acceleration of the bonds as a result of a tardy SEC filing.

Defaults

High-yield indentures contain standard default provisions for the nonpayment of principal or interest. While there is no grace, or cure, period for principal payment defaults, the grace period for nonpayment of interest is typically 30 days. It is also common that issuers have a 30-day grace period after notice to the issuer to comply with the substantive covenants of the indenture before an event of default is deemed to have occurred (which would allow for the exercise of contractual remedies against the issuer). As for more administrative obligations of the issuer under the indenture (e.g., maintaining a registrar for the registration of the bonds), the grace period is typically 60 days following notice to the issuer. High-yield indentures also contain a default provision related to the noncompliance by the issuer with its obligations under other debt instruments (e.g., bank credit agreements), but the default is triggered upon the actual acceleration of indebtedness (a "cross-acceleration" provision) by the other lender, not simply the right of the other lender to accelerate (known as a "cross-default" provision, which is the standard in bank credit agreements).

Amendments/Waivers

The general rule for amendments in high-yield transactions is that the issuer needs to obtain the consent of a majority in principal amount of the outstanding bonds in order to effect amendments or waivers to the indenture. To the extent that the issuer does seek the consent of holders and offers to pay them for their consent, many indentures require the issuer to offer to pay a consent fee to every holder that is willing to provide its consent in the prescribed time period. The indenture usually includes a list of those items in the indenture, generally related to the "money terms," such as principal, interest rate, and maturity, that may not be amended except with the unanimous consent of the holders.

There usually are also included a list of amendments that can be made without the consent of any holder on the theory that amendments are harmless to the bondholders (e.g., clarifying ambiguities, adding covenants on the part of the issuer, adding guarantees).

Defeasance

Keeping in mind that the issuer is typically subject to some period during which it is not entitled to redeem the bonds, the indenture does allow the issuer at any time to escape the restrictions in the covenants through the mechanism of defeasance. Essentially the issuer is required to deposit in trust with the bond trustee enough cash or government securities with a present value based on calculations confirmed by an independent accounting firm so that there will be sufficient cash available, after taking into account the earnings on the deposited funds, to pay all the interest and principal of the bonds when they are due. Once the issuer has made the deposit of cash or government securities into the defeasance trust, it is entitled to ignore the substantive covenants discussed in this chapter. Similarly the related events of default are rendered inoperative.

Defeasance is expensive for an issuer because the earnings growth rate the issuer must use in calculating the minimum cash deposit is low—the U.S. Treasury rate then in effect. As a result, defeasance is not an attractive option to most issuers. A common alternative is for issuers to offer to buy the bonds from holders in a tender offer that is usually accompanied by a solicitation by the issuer for consent of the tendering holders to amendments to the indenture. As long as a majority of the holders give their consent, then the issuer can usually achieve its goal of obtaining relief from the covenants, and the price that it needs to pay to clear the market is usually less expensive than the defeasance option.

Conclusion

In this chapter we attempt to describe the common characteristics of high-yield bonds as well as the most common covenants that can be found in high-yield indentures. Every bond indenture is different, however, and in practice significant variations will be found both in the types of covenants and in the types of exceptions to the covenants based on the issuer's industry, the proposed ratings on the bonds, general economic and market conditions, and the sophistication and experience of the issuer and its counsel. In reviewing actual covenant language, it bears repeating that the language of the accompanying definitions is critical. Well-crafted high-yield covenants will usually strike a balance between the bondholders' reasonable and legitimate expectations for the protection of their investment and the legitimate needs of an issuer to have the flexibility to grow its business in accordance with its stated business strategy.