MAYER • BROWN

High-Yield Bonds

An Issuer's Guide (U.S. Edition)

CONTENTS

High-Yield in Context

High-Yield Bonds Compared to Traditional Bank Financing

High-yield bonds (or notes) provide issuers with the benefits associated with long-term debt financing but with covenants that are typically less onerous than standard credit facility covenants, and can be self-administered rather than requiring an ongoing dialogue with creditors. The high-yield bond covenant package largely does not include traditional bank financing maintenance covenants, which require that the Issuer maintain a certain financial health or the lenders can call or accelerate the loans. Instead, the high-yield covenant package includes incurrence covenants, which require the Issuer (and its Restricted Subsidiaries) to take some action, such as incur indebtedness, pay a dividend or make an investment, in order to be triggered. Moreover, such covenants are designed to scale with the Issuer's business as it grows in size over the lifetime of the bonds.

As a whole, the high-yield covenant package has been designed to (i) prevent the Credit Group (consisting of the Issuer, any Guarantors and all Restricted Subsidiaries) from becoming over-leveraged by either borrowing too much or decreasing its cash-generating assets without concurrently decreasing its debt, (ii) protect the position of noteholders in the Credit Group's capital structure by limiting the ability of the Credit Group to effectively subordinate the bonds through structural or lien subordination and (iii) preserve the assets of the Credit Group and the Issuer's access to such assets. High-yield covenants place restrictions (with numerous carve-outs that will be discussed later) on the ability of the Credit Group to:

- Incur additional debt;
- Pay dividends, invest outside the Credit Group or make certain other restricted payments that would result in value leakage out of the Credit Group;
- Grant security interests on its assets (securing indebtedness other than the bonds);
- Sell assets and subsidiary stock;
- Enter into affiliate transactions;
- Issue guarantees of debt incurred by others;
- Engage in mergers or consolidations or sell substantially all of the Issuer's or a Guarantor's assets;
- Enter into transactions that would fundamentally alter the ownership structure of the credit group; and
- Agree to restrictions on distributions and transfers of assets within the Credit Group.

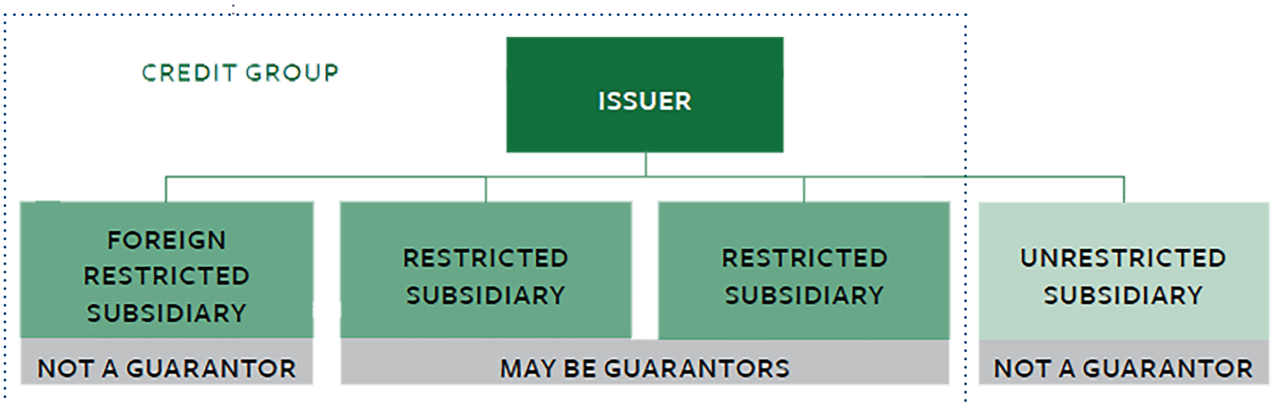
The Ideal High-Yield Bond Candidate

High-yield bond issuers are typically (i) established companies without investment-grade ratings looking to offer debt, (ii) private companies looking to reorganize their capital structures or (iii) companies that are the targets of a leveraged buyout financing. High-yield issuers exhibit some or all of the following characteristics:

- Stable and resilient business model;
- Strong financial track record;
- Growth or recovery story;
- Market-leading positions in their industry or geography;
- Favorable industry trends;
- Experienced management team with proven track record;
- Solid cash generation and future deleveraging potential; and
- Financing needs of at least $100 million.

The Credit Group and Building the Credit Story

The Issuer, any Guarantors and all Restricted Subsidiaries constitute the "**Credit Group**" and fall within what is referred to as "the box." Only the entities comprising the Credit Group (or those within the box) are subject to the covenant package, and the covenants aim to protect the holders of the bonds from diminution in the assets and creditworthiness of the Credit Group during the lifetime of the bonds. The financial strength and asset quality of the Credit Group form the basis of the credit story presented to investors and ratings agencies and ultimately impact the marketability and pricing of the bonds. Set forth below is an illustration of a typical Credit Group:



THE ISSUER

The selection of the entity to act as the Issuer of the bonds depends on a variety of factors such as the capital structure of the company and any existing senior debt permitted under its current obligations. The Issuer could be the ultimate parent holding company, an intermediate operating holding company or a lower-level operating company. See "*General Observations—Subordination*" for a discussion regarding how the choice of entity impacts investors' analysis of the credit story.

SUBSIDIARIES: RESTRICTED AND UNRESTRICTED

Unless expressly designated as Unrestricted Subsidiaries, all subsidiaries of the Issuer are Restricted Subsidiaries, meaning that their activities are subject to and limited by the covenant package contained in the indenture governing the bonds.

Unrestricted Subsidiaries are, by definition, not part of the Credit Group and are not subject to the covenant package. In addition, the financial results of Unrestricted Subsidiaries are not included in the calculation of financial ratios under the covenants and therefore do not affect (positively or negatively) covenant compliance for the Credit Group. In addition, intercompany transactions between Unrestricted Subsidiaries, on the one hand, and the Issuer and the Restricted Subsidiaries, on the other hand, are subject to greater limitations than those solely between and among Restricted Subsidiaries and the Issuer, as the high-yield covenant package seeks to limit activities by the Credit Group where value may be transferred outside the box. The Issuer may grow new businesses outside the constraints of the indenture covenants by forming Unrestricted Subsidiaries or designating Restricted Subsidiaries as Unrestricted Subsidiaries.

THE GUARANTORS

High-yield bonds are frequently guaranteed by most, if not all, of the Issuer's domestic Restricted Subsidiaries ("**Upstream Guarantees**"), and in secured offerings, such Guarantors also typically provide asset security for the bonds. The Upstream Guarantees give noteholders a direct claim against the relevant Guarantor subsidiaries and their assets in the event of default by the Issuer, which overcomes some structural subordination issues. See "*General Observations — Subordination–Structural Subordination.*" If the Issuer is an entity other than the ultimate parent company, there may also be a parent guarantee ("**Downstream Guarantee**") in order to provide additional financial support to its subsidiary Issuer.

Often, however, a Restricted Subsidiary is required to guarantee the bonds only if it guarantees other debt of the Issuer and another Guarantor.

Foreign subsidiaries of U.S. Issuers usually do not act as guarantors because, under U.S. tax law, a guarantee by a foreign subsidiary of a U.S. parent company's debt is deemed a dividend, subject to certain exemptions. Additionally, in some jurisdictions, foreign subsidiaries simply cannot serve as Guarantors due to regulatory hurdles or prohibitions related to such foreign subsidiary guaranteeing offshore debt.

General Observations

This section provides a high-level overview of some of the general principles of a high-yield covenant package.

Overall Objective and Process of Negotiating a High-Yield Covenant Package

The overall objective in negotiating a high-yield covenant package is to ensure adequate protections for the future holders of the bonds (i.e., there is little point in negotiating a highly "issuer friendly" package that may be perceived as "off market" and, therefore, may potentially not be acceptable to investors or result in a higher coupon) while preserving the necessary operating and financial flexibility to allow the Issuer to execute its business plan.

It is, therefore, critical for all parties involved in the drafting process to analyze and be fully familiar with the Issuer's existing organization and capital structure and with the Issuer's business plan. In particular, it will often save significant time and energy during the negotiation process if the parties take sufficient time at the outset of a transaction to consider and explore all reasonably foreseeable transactions and activities that the Issuer may engage in while the bonds will be outstanding and that might be restricted under the covenants, including (i) future acquisitions, joint ventures or other investments, (ii) future financing plans (e.g., equipment financing, sale leaseback transactions, receivable financings or other secured debt transactions), (iii) debt or debt-like arrangements incurred in the ordinary course of business, (iv) plans for potential geographic expansion and/or new lines of business, (v) the need for letters of credit or other credit enhancements, (vi) expected intra-group funds flows and (vii) potential related-party transactions.

As a practical matter, counsel for the underwriters typically prepares the first draft of the "**Description of the Notes**" for the offering memorandum, which will closely track (largely verbatim) the relevant contractual provisions that will later be included in the indenture. Although Issuer's counsel will then take a leading role in "marking up" this initial draft, it is essential that senior management of the Issuer and its financing and accounting staff are closely involved in this process as outside counsel cannot be expected to anticipate all flexibility the Issuer may need during the term of the bonds. See "*High-Yield Bond Covenant Package*."

"INCURRENCE" VS. "MAINTENANCE" COVENANTS

Unlike a typical senior credit facility, a high-yield indenture will not include any so-called maintenance covenants that require the Credit Group to maintain or improve certain financial ratios or metrics over time. Maintenance covenants can be breached, not necessarily by the Issuer or its subsidiaries taking any affirmative action per se, but simply by the Issuer and its subsidiaries having poor operating or financial results, which often is not within the control of the Issuer. Instead, high-yield covenants will be triggered only upon the taking of certain actions, such as incurring additional indebtedness or making so-called Restricted Payments (as defined below).

"BASKETS"

The Issuer's and each Restricted Subsidiary's ability to engage in certain types of transactions that are restricted by a particular covenant will often depend on the capacity available under so-called "baskets." "Basket" is a term used to describe the method by which the covenants define the capacity of the Credit Group to engage in certain types of activity restricted by a particular covenant. For example, the Limitation on Indebtedness Covenant may include several specified baskets, including possibly a basket for local currency debt issued by foreign subsidiaries (for working capital purposes) and, most importantly, a basket for indebtedness issued under the Issuer's senior credit facilities.

Certain baskets may grow and become depleted over time (e.g., baskets that are based on accumulated consolidated net income of the Issuer, reduced by the aggregage amount of Restricted Payments made, respectively, since the date of issuance of the bonds) and/or be "refillable," while other baskets may be "one-time only." The Issuer would obviously prefer to be able to refill baskets, for example, as indebtedness incurred under a particular basket is repaid, and refillable baskets have become more common. While many baskets are traditionally expressed as specified fixed amounts in the currency of the bonds, many transactions increasingly use "soft caps" that are expressed as the greater of a fixed amount and a percentage of, for example, total assets. These soft caps reward Issuers for strong financial performance and provide them with flexibility for growth over the lifetime of the bonds.

In addition to specific baskets for specific categories of transactions, covenants may also contain a so-called "general" or "hell or high water" basket, which may, for example, permit a limited amount of indebtedness to be incurred for any reason or no reason at all. Issuers should guard this basket carefully, as "hell or high water" events tend to occur far more frequently during the lifetime of the bonds than the parties normally expect at the outset. It is important that the Issuer preserve, as much as possible, the capacity available to it under the various baskets. This is because, as a general matter, it will always be more advantageous to the Issuer to designate a transaction as having taken place pursuant to a general (i.e., "non-dollar restricted basket") exemption to a covenant or pursuant to a basket designed for a specific category of transactions, rather than pursuant to a general basket.

DURATION OF COVENANT RESTRICTIONS

Generally, the covenants will apply as long as the bonds are outstanding. While waivers and amendments under traditional senior credit facilities are relatively common and uncomplicated, waivers and amendments to high-yield bond indentures typically require the Issuer to solicit consents from a qualified majority of, or possibly all, noteholders, which can be costly and time-consuming.

It is, however, possible to negotiate fall-away covenants or suspension covenants. Under fall-away covenants, if the Issuer's long-term debt receives an investment-grade rating from two out of three rating agencies, most of the high-yield covenants are automatically deemed eliminated (i.e., they fall away forever) and only investment-grade covenants will remain. In a typical fall-away scenario, the remaining investment-grade covenants are: limitation on liens; limitation on merger, consolidation, and sale of substantially all assets; change of control covenant; and reporting covenant.

Suspension covenants, however, are only in place while the Issuer is rated sub-investment grade. If the Issuer gains an investment-grade rating, such covenants are suspended. However, if the Issuer's investment-grade rating is lost, then the high-yield covenants will resume (meaning that the covenant package "springs" back into existence).

Subordination

High-yield bond are sometimes structured to be junior to bank debt (i.e., subordinated) because subordination allows the Issuer to incur debt more cost effectively than it could if all of its debt was senior. High-yield bonds can be either (i) expressly subordinated and referred to as subordinated notes or (ii) structurally subordinated and still referred to as senior notes.

The methods of subordination are contractual subordination, structural subordination and lien subordination. Only subordinated notes have express contractual subordination provisions, while structural and lien subordination may be a feature of both senior notes and subordinated notes.

CONTRACTUAL SUBORDINATION

High-yield bonds are contractually subordinated when the debt is expressly subordinated by its own terms. Although a full discussion of the many issues raised by express subordination is beyond the scope of this guide, under a typical subordinated high-yield bond structure, the subordinated noteholders agree that:

- upon the Issuer's bankruptcy or liquidation, they will not be paid until the senior debt is paid in full; and
- if any payment default of the senior debt has occurred and is continuing, any amounts received by the subordinated debt holders will be allocated to any senior debt holders until the senior debt is paid in full.

If any nonpayment default of the senior debt has occurred and is continuing, the subordinated notes become subject to payment blockage provisions in the indenture, whereby no payments are permitted to be made on subordinated debt for a specified period of time.

Additionally, the indenture will include standstill provisions, whereby the high-yield noteholders are required to give the senior lenders notice and wait for a certain period of time before accelerating the subordinated debt.

It should be noted that certain covenants in a subordinated note indenture will in some respects be different than those of a senior note indenture. For example, most unsecured subordinated note indentures permit all senior indebtedness of the Issuer and its Restricted Subsidiaries to be secured.

PRACTICE TIP

When reviewing other deals to determine what is "market precedent" it is important to not compare the covenants contained in a senior note indenture to the covenants in a subordinated note indenture or the covenants contained in a secured note indenture to an unsecured note indenture, as significant differences are to be expected. It is also good practice to obtain precedents of other companies that are in the same industry of the Issuer, while unsecured senior note indentures will only allow a limited amount of other senior debt to be secured.

STRUCTURAL SUBORDINATION

In the most common form of structural subordination, high-yield bonds are issued by a holding company without the benefit of any Upstream Guarantees, while the structurally senior debt is issued by the operating company or subsidiaries where the operations and assets of the Issuer reside. The structurally senior debt may have restrictions on the ability of the operating company to make dividends and other payments to the Issuer holding company ("**Dividend Stoppers**").

The structurally subordinated notes are effectively junior in right of payment to the senior debt because there are no Upstream Guarantees by the operating company or its subsidiaries, and, therefore, the operating company and its subsidiaries are not obligated to make payments on the bonds. As a result, noteholders and other creditors of the Issuer holding company have no direct access to the assets or cash of the operating company and its subsidiaries. The only claim the Issuer holding company creditors have on the assets of the operating company and its subsidiaries is through the equity of the operating company held by the Issuer holding company (i.e., an equity holder claim). In a bankruptcy or liquidation of the operating company, the claims of the Issuer holding company's creditors would be junior to the claims of all creditors of the operating company and its subsidiaries, including the claims of unsecured creditors, such as subordinated debt holders and trade creditors.

LIEN SUBORDINATION

For most non-investment-grade Issuers, senior bank debt will often be secured by a first-priority lien on all or substantially all of the Issuer's and its subsidiaries' assets. High-yield bonds may be secured or unsecured. If secured, it can be either first-lien secured debt (in which case it is not subordinated) or second-lien secured debt. If the bonds are first-lien secured debt, they will share the proceeds from collateral *pari passu* with the first-lien senior bank debt, while second-lien bonds will receive proceeds from collateral only after first-lien senior bank debt has been paid in full. However, in either case, the security interest of the high-yield bonds is generally silent, meaning the senior bank debt determines enforcement remedies with respect to the collateral. If the high-yield bonds are secured, an intercreditor agreement will set forth the rights and limitations as between the secured creditors with respect to the collateral. See "*Documentation – Intercreditor Agreement*."

The High-Yield Bond Covenant Package

This section provides a high-level overview of a number of the most significant high-yield bond covenants. The actual terms of the bonds will be described in a detailed "Description of the Notes" section in the offering memorandum that will be prepared for the offering. The covenants reviewed are applicable to unsecured unsubordinated notes, which is typical of most high-yield bond offerings. The covenants for secured or subordinated notes will have important differences from those reviewed below. Issuers should carefully review and analyze with legal counsel the full contractual terms of any high-yield bonds as described in the offering memorandum and reflected in the indenture to ensure that the covenant package is tailored for the specific operational needs of the Issuer.

PRACTICE TIP

In calculating the Fixed Charge Coverage Ratio, pro forma effect is to be given to debt incurred and repaid during the calculation period. An often-overlooked exclusion to this general calculation is how to treat revolving credit borrowings and repayments. To avoid this uncertainty, such borrowings and repayments should be excluded.

A point of negotiation is whether all pro forma adjustments must comply with Article II of Regulation S-X, which generally permits only adjustments for items relatively certain to occur. Some indentures add additional adjustments based upon the Issuer's good faith estimates.

Limitation on Indebtedness

The purpose of the Limitation on Indebtedness Covenant is to (i) limit the amount of additional debt that may be incurred by the Credit Group unless cash flow is sufficient to service all debt and (ii) control structural subordination by specifying where additional debt can be incurred. See "*Subordination – Structural Subordination*." The covenant includes a general prohibition on the incurrence of indebtedness unless a ratio test is satisfied (so-called "**Ratio Debt**") and exceptions to such general prohibition (such exceptions defined as "**Permitted Debt**"). Indebtedness is generally broadly defined to include guarantees, letters of credit, capital lease obligations, hedging obligations, disqualified stock of the Issuer, any preferred stock of Restricted Subsidiaries and the deferred purchase price for any assets that remain unpaid for a specified period of time; however, Issuers may want to negotiate items that are expressly excluded as indebtedness, such as (i) debt that has been defeased, (ii) contingent letters of credit and surety bonds, (iii) debt repayable in equity and (iv) purchase price adjustments. For oil and gas companies issuing high-yield bonds, additional exclusions may include (i) farm-in agreements, (ii) commodity hedges and (iii) overriding royalty agreements and other obligations payable in production.

THE "COVERAGE RATIO" EXEMPTION

The most common ratio test that is used in conjunction with the Limitation on Indebtedness Covenant is the "**Fixed Charge Coverage Ratio**" (i.e., the Issuer and its Restricted Subsidiaries (or often, only those Restricted Subsidiaries that are Guarantors) will only be permitted to incur additional indebtedness (other than Permitted Debt) so long as the Fixed Charge Coverage Ratio is at least equal to a predetermined ratio calculated on a pro forma basis after giving effect to the incurrence of the additional debt and the application of the proceeds thereof).

The Fixed Charge Coverage Ratio is a ratio of earnings before interest, taxes, depreciation and amortization ("**EBITDA**") of the Credit Group to fixed charges of the Credit Group. The required ratio is commonly ranges between 2.0 and 2.5 to 1.0. Typically, Issuers are not eligible to incur Ratio Debt when the bonds are issued, and therefore must initially depend upon the Permitted Debt exceptions to incur additional indebtedness.

The definition of EBITDA is complex and often uniquely tailored to the Issuer's industry accounting approach but is generally defined as GAAP net income with income taxes, depreciation and amortization expense added back to it.[1]

Fixed charges primarily include (i) interest expense (cash and non-cash), (ii) amortization of debt issuance costs and original interest discount, (iii) the interest component of capital leases, (iv) dividends on preferred stock and (v) net payments under hedging obligations. It may also include, for certain types of businesses, other charges or expenses (e.g., for retail- and real estate-based Issuers, fixed charges could also include rental expenses).

The Fixed Charge Coverage Ratio is calculated based on the operating results of the Credit Group for the immediately preceding four quarters for which financial statements are available and gives pro forma effect to the incurrence of debt proposed to be incurred, incurrence and retirement of other debt from the beginning of the four-quarter period until the calculation date, and acquisitions and dispositions during the same period.

Because the covenant is an "incurrence" covenant, it only tests the ratio at the time the Issuer or a Restricted Subsidiary incurs additional indebtedness as Ratio Debt. An Issuer is permitted to maintain Ratio Debt even if its subsequent financial performance would prevent it from later incurring additional Ratio Debt.

THE PERMITTED DEBT EXEMPTION

The covenant will also permit numerous categories of "**Permitted Debt**" to be incurred by the Issuer and its Restricted Subsidiaries regardless of their financial performance or condition and without their having to meet the Fixed Charge Coverage Ratio test. The specific categories of indebtedness covered by this exemption will be negotiated between the Issuer and the underwriters and set forth in the text of the Limitation on Indebtedness Covenant. Permitted Debt typically includes:

- Debt under the "**Credit Facilities Basket**," which would include the Issuer's existing credit agreement and any refinancings thereof, as well as any other indebtedness meeting the definition of "credit facility" (subject to a fixed cap but sometimes with a "grower" component);

1 Alternatively, EBITDA can also be defined as Adjusted Net Income *plus* interest *plus* taxes *plus* depreciation and amortization *plus* non-cash charges decreasing net income *minus* non-cash items increasing net income. Adjusted Net Income is customarily defined as follows: GAAP net income (or loss) of the Credit Group, adjusted by excluding: (i) any gain (but not loss) on any asset sale, (ii) any extraordinary gain (but not loss), (iii) net income (but not loss) of an entity that is not a Restricted Subsidiary, except to the extent distributed to the Issuer or a Restricted Subsidiary, (iv) net income of a Restricted Subsidiary to the extent restricted from being distributed to the Issuer or a Restricted Subsidiary and (v) the cumulative effect of a change in accounting principles.

PRACTICE TIP

All or some of such adjustments described above may be made to EBITDA directly, as opposed to Net Income. The difference may be important. Net Income is used to calculate the Net Income Basket for Restricted Payments. Therefore, an Issuer will prefer to adjust Net Income, while investors will prefer to allow such adjustments only to EBITDA for purposes of the Limitation on Indebtedness Covenant.

Underwriters will typically prefer that only the Issuer and Guarantors are permitted to incur Ratio Debt, thus limiting structural subordination due to non-guarantor Restricted Subsidiaries incurring unlimited Ratio Debt.

This exception is (i) typically permitted only up to a fixed amount (some amount greater than the maximum commitment under the existing credit agreement), although sometimes the limitation is defined as the greater of a fixed amount and a borrowing base or other "grower" component (such as consolidated net assets) and (ii) sometimes reduced to the extent permanently repaid with net proceeds of asset sales. As in the case of Ratio Debt, it is a negotiated point whether the Issuer and all Restricted Subsidiaries, or only the Issuer and its Guarantors, may incur debt under this exception. Indentures typically provide that any debt outstanding on the issue date under the Credit Facilities Basket cannot be redesignated as Ratio Debt or other Permitted Debt. Some indentures further prohibit such redesignation as to future debt incurred under the Credit Facilities Basket. Without such a limitation, the Credit Facilities Basket may be "emptied out," and thus allow for additional leverage. As this exception is typically allowed as secured debt, such a scenario may significantly increase the amount of permitted structurally senior debt. "Credit Facilities" is typically defined as any type of borrowed debt (including debt securities).

PRACTICE TIP

Practitioners often question whether an initial debt incurrence may be divided between Ratio Debt and Permitted Debt, and if so, whether the portion allocated to Permitted Debt should be given pro forma effect in the calculation of the Fixed Charge Coverage Ratio. Many indentures specifically address this question by providing that the portion allocated to Permitted Debt, as well as the discharge of any Permitted Debt with the proceeds of such allocated amount, shall be ignored for purposes of calculating the amount of Ratio Debt that may be incurred.

- Ordinary course debt, such as letters of credit supporting workers' compensation claims, self-insurance obligations, performance, surety, appeal or similar bonds;
- Debt existing on the issue date that is not otherwise included within any other Permitted Debt exception. This exception typically excludes debt outstanding on the issue date that is permitted by the Credit Facility Basket or other identified Permitted Debt exceptions so as to prevent the Issuer from "emptying-out" such other baskets by redesignating such debt as "debt existing on the issue date";
- Debt represented by the notes issued on the issue date and any related guarantees (together with any registered exchange notes and related guarantees). Note: Because "notes" is typically defined to include all notes issued under the indenture, if the indenture permits follow-on notes to be issued in the future, it is typical for this exception to be limited to the initial notes so that any additional notes would have to be issued in compliance with other exemptions;
- Permitted Refinancing Debt (i.e., debt incurred to refinance Ratio Debt or other certain identified categories of Permitted Debt);
- Capitalized leases, mortgage financings and purchase money obligations, all subject to a cap;
- Intercompany borrowings between and among the Credit Group;
- Hedging obligations incurred for non-speculative purposes;
- Negotiated basket available to the Issuer and all Restricted Subsidiaries (not only Guarantors) (typically a fixed amount but sometimes with a "grower" component) for any purpose; and
- Other specific carve-outs (e.g., foreign subsidiary debt under local lines of credit).

AVAILABILITY OF EXEMPTIONS

To the extent the incurrence of a specific item of indebtedness satisfies more than one exemption or basket, the Issuer has the right under the Limitation on Indebtedness Covenant to designate the specific exemptions or baskets under which the relevant item of indebtedness is being incurred.

Generally, the Issuer may, at any time, reclassify any item of indebtedness that at such time meets the requirements of one or more exemptions (other than Indebtedness incurred under the Credit Facilities Basket). If the financial performance of the Issuer improves (resulting in increased debt incurrence capacity under the Fixed Charge Coverage Ratio exemption), the Issuer will also typically be permitted to reclassify debt initially incurred under one or more Permitted Debt baskets as Ratio Debt, thereby freeing up capacity under the relevant Permitted Debt baskets. Such a reclassification is also advantageous in the event of a refinancing of Permitted Debt. For example, refinancing debt with Ratio Debt need not comply with the limitations required by the definition of Permitted Refinancing Debt.

OTHER COVENANTS THAT MIGHT BE RELEVANT

In evaluating whether the Limitation on Indebtedness Covenant provides sufficient flexibility for the Issuer, the Issuer and its advisers should also consider:

- The Limitation on Liens Covenant, if the Issuer intends to incur indebtedness that is secured by any liens;
- The Limitation on Restrictions on Dividends and Other Payments from Restricted Subsidiaries Covenant, since the incurrence of additional indebtedness may involve the imposition of contractual restrictions on dividends, asset transfers and other payments by the borrowing subsidiaries; and
- The Asset Sales Covenant, which often requires that any repayment of indebtedness with Asset Sale proceeds must be accompanied by a commitment reduction.

Limitation on Restricted Payments

The Limitation on Restricted Payments Covenant is designed to prevent cash and assets from being transferred outside the Credit Group (also referred to as "leakage"), subject to certain exceptions, unless the Credit Group's positive performance or improved financial condition justifies its ability to make such payments. This protection is important to noteholders, because it preserves the Issuer's ability to repay its indebtedness, as well as preserving assets in the Credit Group in the event of insolvency or bankruptcy.

The covenant is structured in three parts: (i) the definition of Restricted Payments, (ii) the calculation of the Net Income Basket (sometimes referred to as the "Restricted Payments Builder Basket") and the conditions under which a Restricted Payment may be made under the Net Income Basket and (iii) exceptions to the limitation on Restricted Payments (i.e., instances when Restricted Payments may be made even if the conditions under the Net Income Basket are not met).

DEFINITION OF RESTRICTED PAYMENTS

"Restricted Payments" are typically defined as including any of the following actions by the Credit Group:

- Paying cash dividends or making other distributions of assets to stockholders; provided, however, dividends paid in stock (other than disqualifying stock) and dividends paid by a Restricted Subsidiary to the Issuer or another Restricted Subsidiary are excluded (i.e., are not Restricted Payments or are otherwise permitted exceptions);
- Repurchasing capital stock of the Issuer;
- Repaying subordinated debt prior to scheduled maturity; and
- Making Investments outside the Credit Group (other than Permitted Investments, which are discussed below).

PRACTICE TIP

It will almost always be advantageous for the Issuer to designate, to the maximum extent possible, an incurrence of indebtedness to have been made as Ratio Debt, as opposed to pursuant to a specified Permitted Debt basket amount. This is because any indebtedness incurred in reliance on a basket will be factored in when calculating future compliance with the Fixed Charge Coverage Ratio anyway and also use up capacity under the basket.

Typically, the Permitted Refinancing definition will restrict the amount, maturity, amortization, obligors, collateral and subordination of the refinancing indebtedness. A typical exception to such restrictions is debt under the Credit Facilities Basket, which may be refinanced without such limitations. Similarly, the definition of Permitted Refinancing Indebtedness often does not expressly prohibit a non-guarantor Restricted Subsidiary from incurring debt to refinance debt of a guarantor. The Issuer and investors should consider if they agree to permitting subordinated debt to be refinanced with senior debt and *pari passu* debt to be refinanced with structurally senior debt, resulting in increased structural subordination of the bonds.

PRACTICE TIP

Further, indentures often mistakenly do not provide that any Permitted Debt basket that is refinanced by the Permitted Refinancing exception should not thereby "empty out" such Permitted Debt basket. Unless each Permitted Debt basket also includes in its calculation of the maximum amount that can be incurred thereunder any debt refinancing such debt, this outcome will occur and thus permit an Issuer to become more highly leveraged than the noteholders may have expected.

The term "Investment" is defined very broadly and consists generally of:

- Purchases of equity or debt securities of another entity;
- Capital contributions to any entity; and
- Loans to, or guarantees or other credit support for, the benefit of any entity.

Investments are generally treated as Restricted Payments because they typically involve assets of the Issuer or its Restricted Subsidiaries being transferred to a third party outside the Credit Group. Because Investments may be both Permitted Investments and Restricted Payments, it is important to remember the Issuer is permitted to aggregate multiple baskets to make an Investment.

The covenant does not restrict acquisitions of companies that become Restricted Subsidiaries, capital expenditures, and most intra-group loans and guarantees, as all of these transactions represent investments "in the system" within the Credit Group.

CALCULATION OF THE NET INCOME BASKET

The Net Income Basket is calculated as follows:

- 50 percent cumulative Adjusted Net Income (minus 100 percent of any loss) for the period from the beginning of the quarter immediately prior to or after the date the bonds are originally issued until the end of the most recent quarter for which financial statements are available; plus
- Cash proceeds (and often the fair market value of any assets) from (i) capital contributions to the Issuer, (ii) issuances of equity by the Issuer (other than (x) disqualified stock and (y) issuances to a subsidiary) and (iii) issuances since the issue date of the bonds of *pari passu* or senior debt of the Issuer and its Restricted Subsidiaries subsequently converted or exchanged (other than by a subsidiary of the Issuer) into Issuer equity (other than disqualified stock); plus
- Net reductions in Restricted Investments that have been made under the Net Income Basket (to the extent not included in Adjusted Net Income), such as:
  - » the aggregate net proceeds (including the fair market value of assets other than cash) received by Issuer or any Restricted Subsidiary upon the sale or other disposition of any Investment made pursuant to the Net Income Basket;
  - » the net reduction in Investments made pursuant to the Net Income Basket resulting from dividends, repayments of loans or advances or other transfers of assets to Issuer or any Restricted Subsidiary;
  - » to the extent that the amount available for Investments under the Net Income Basket was reduced as the result of the designation of an Unrestricted Subsidiary, the portion (proportionate to Issuer's equity interest in such Subsidiary) of the fair market value of the net assets of such Unrestricted Subsidiary at the time such Unrestricted Subsidiary is redesignated, or liquidated or merged into, a Restricted Subsidiary; and
  - » the net reduction in Investments made pursuant to the Net Income Basket resulting from repayment of letters of credit, the expiration of a letter of credit undrawn or the release of any guarantees.

- A negotiated dollar amount (in some cases).

CONDITIONS TO USE OF NET INCOME BASKET

Restricted Payments cannot be made utilizing the Net Income Basket unless:

- the amount of the proposed Restricted Payment plus all prior Restricted Payments since the original issue date of the bonds (subject to certain exceptions discussed below) does not exceed the amount of the Net Income Basket;
- the Issuer can incur U.S.$1.00 of Ratio Debt under the Limitation on Indebtedness Covenant (after giving pro forma effect to the Restricted Payment); and
- no default exists or would exist under the indenture after giving effect to the Restricted Payment (i.e., the Issuer must give pro forma effect of the Restricted Payments when calculating the Restricted Payments covenant compliance).

PERMITTED RESTRICTED PAYMENTS

Certain Restricted Payments can be made without regard to the Net Income Basket or the conditions to using the Net Income Basket ("**Permitted Restricted Payments**"), and they include:

- the acquisition of equity out of the proceeds of, or in exchange for, a concurrent issuance of new equity;
- repurchases of subordinated debt out of proceeds of concurrent issuance of new equity or new subordinated Permitted Refinancing Debt;
- a general basket for any Restricted Payment, subject to an aggregate dollar cap;
- pro rata dividends of Restricted Subsidiaries paid to third parties; and
- other negotiated exceptions (e.g., limited investments, limited repurchase of management stock or specific exceptions necessitated by the Issuer's capital structure).

As a general matter, all Permitted Restricted Payments count against the Net Income Basket other than Restricted Payments that either:

- expressly provide that the assets or cash utilized in such Permitted Restricted Payment do not also build the Net Income Basket (e.g., those made with the proceeds of, or in exchange for, an equity issuance);
- are credit-neutral (e.g., the permitted refinancing of subordinated debt); or
- are *de minimis* (loan to officers, etc.).

PERMITTED INVESTMENTS

Permitted Investments are, by definition, not Restricted Payments. Permitted Investments generally include:

- investments in the Issuer, any Restricted Subsidiary (sometimes limited to Investments in Guarantors) or any entity that becomes a Restricted Subsidiary as a result of the Investment;
- certain enumerated hedging transactions;

PRACTICE TIP

To avoid double counting, investors will want to make sure that if capital contributions or equity proceeds are a separate basis for making a Permitted Investment or Permitted Restricted Payment, any capital contribution or equity proceeds used for those specific exceptions is not also used to increase the amount of the Net Income Basket.

- loans or advances to officers or directors, subject to a cap;
- investments in joint ventures, subject to a cap; and
- other Investments, subject to a cap.

AVAILABILITY OF EXCEPTIONS

In the event that a Restricted Payment or Permitted Investment meets the criteria for incurrence under the Net Income Basket and/or more than one of the types of Permitted Restricted Payments or Permitted Investments, most indentures will generally permit the Issuer, in its sole discretion, to classify and, from time to time, to reclassify any such item. In particular, if the financial performance of the Issuer improves (resulting in availability under the Net Income Basket), the Issuer will typically (but not always) be permitted to reclassify any item initially incurred under one or more Restricted Payment Baskets or Permitted Investments baskets as a Restricted Payment under the Net Income Basket, thereby freeing up capacity under the relevant baskets.

OTHER COVENANTS THAT MIGHT BE RELEVANT

A guarantee of the debt of others is both indebtedness and an Investment. Therefore, prior to incurring a guarantee, the Issuer must make sure availability exists under the Restricted Payments Covenant and the Limitation on Indebtedness Covenant.

LIMITATION ON DIVIDENDS AND OTHER PAYMENT RESTRICTIONS FROM RESTRICTED SUBSIDIARIES

The purpose of this covenant (often called the "Limitation on Dividend Stoppers Covenant") is to prevent cash flow needed to service debt of the Issuer from being trapped at a subsidiary level (i.e., noteholders want all cash generated by Restricted Subsidiaries to be able to freely flow up to the Issuer so that it may be used to satisfy its obligations under the bonds). As such, the covenant is a general prohibition on the existence of any restriction on Restricted Subsidiaries (alternately, sometimes limited to non-Guarantors) to pay dividends, repay indebtedness, make loans or otherwise transfer assets to the Issuer or any other Restricted Subsidiary. This covenant is important to investors because they look to the credit quality and financial condition of the Issuer and its Restricted Subsidiaries as a whole for the repayment of the bonds, not just the Issuer.

Common exceptions to the covenant include:

- restrictions existing in existing indebtedness (and sometimes any other indebtedness that is permitted to be incurred);
- restrictions already in place when a subsidiary is acquired (provided such restrictions are not incurred in anticipation of such acquisition);
- applicable law;
- customary lease provisions; and

PRACTICE TIP

Permitted Investments are specifically excluded from the definition of Restricted Payments. As such, because they are not Restricted Payments, they do not count against the Net Income Basket. Consequently, an Issuer will prefer that an Investment be permitted as a Permitted Investment rather than as a Permitted Restricted Payment.

An Issuer will want to provide that any Investments made pursuant to a general exception over time that results in such entity becoming a Subsidiary will automatically be made under the "Investments in Subsidiaries" exception, thus "emptying out" the general exception.

An Issuer will want to provide that any Restricted Payment or Permitted Investment basket subject to a cap should be netted against any distributions and returns on Investments made pursuant to such baskets.

- restrictions in refinancings of existing debt, if the limitations are not more restrictive than those being refinanced.

Joint ventures entered into by the Issuer or its Restricted Subsidiaries may present obstacles in the context of the limitation on restrictions on distributions from Restricted Subsidiaries because the partner in such joint venture will typically have veto rights over dividend payments. One possible solution is the formation of a joint venture that is less than 50 percent Issuer-owned; such a joint venture would not be a "Subsidiary" and thus would not be a Restricted Subsidiary subject to the indenture covenants. However, any investment in the joint venture would then count as a Restricted Payment that would be subject to the requirements of the Limitation on Restricted Payments covenant.

OTHER COVENANTS THAT MIGHT BE RELEVANT

The Limitation on Dividend Stopper Covenant should be reviewed in conjunction with the Limitation on Indebtedness Covenant since indebtedness that otherwise may be incurred may be limited by this covenant if the terms of the additional indebtedness contain any provisions that restrict the movement of cash or assets around the Credit Group.

Limitation on Liens

The Limitation on Liens Covenant limits the Issuer's ability to effectively subordinate the bonds through lien subordination. The covenant restricts liens on assets securing indebtedness unless the bonds are equally and ratably secured, subject to certain exceptions ("**Permitted Liens**").

Permitted Liens typically include:

- Liens securing debt permitted under the Credit Facilities Basket;
- Purchase money liens;
- Liens on acquired property that were not incurred in contemplation of the acquisition;
- Liens securing secured Permitted Refinancing Debt, provided the liens are only on the same assets that secured the debt being refinanced; and
- Liens existing on the issue date that are not otherwise included within any other Permitted Lien exception.

OTHER COVENANTS THAT MIGHT BE RELEVANT

It is important to review this covenant in the context of the Limitation on Indebtedness Covenant because it limits the ability to incur indebtedness on a secured basis.

Limitation on Sales of Assets and Subsidiary Stock

Because sales of assets and subsidiary stock may result in income-producing assets being transferred outside the Credit Group, potential noteholders should be aware

PRACTICE TIP

To limit structural subordinations, the exception permitting liens securing credit facilities should be limited to the Credit Facility Basket (i.e., the exception subject to a maximum cap). If the exception instead refers to liens securing any Credit Facility, the effect is to permit all debt that is permitted by the debt covenant (including Ratio Debt) to be secured. Investors may not intend this result.

Most indentures permit "Liens existing on the issue date." Unless that exception further excludes liens securing the Credit Facility Basket (or any other specific categories of existing secured debt), any debt incurred in the future under such debt agreements (such as future revolving borrowings or additional bonds issued under a secured indenture) that may be incurred as Ratio Debt may be incurred as secured Ratio Debt, thus "emptying" the Credit Facility Basket and permitting additional future secured debt. This result may also occur due to a Permitted Lien permitting "liens securing any Permitted Refinancing that refinances secured debt." Unless that exception excludes any secured debt that was incurred under the Credit Facility Basket, if the Issuer is able to incur or refinance debt under the Credit Facility Basket with Ratio Debt or Permitted Refinancing debt, then that refinancing debt can be secured and the Credit Facility Basket will be "emptied," thereby permitting additional secured debt.

PRACTICE TIP

As used in the asset sale covenant in an unsecured unsubordinated indenture, "Senior Debt" should be defined as debt structurally senior to the bonds (e.g., first- lien obligations or debt of non-Guarantor Restricted Subsidiaries (other than intercompany debt)). Debt that is *pari passu* with the bonds should only be permitted to be repaid under this covenant on a pro rata basis with the bonds. Likewise, the definition of "net cash proceeds" should not deduct the repayment of any debt other than "Senior Debt."

To avoid uncertainty regarding the need to segregate asset sale proceeds, the Issuers will want to ensure that the covenant directs the use of "cash equal in amount to the net available cash proceeds," as opposed to the actual cash proceeds. As cash is fungible and as long as the Issuer or the relevant Restricted Subsidiary makes capital expenditures within the relevant time frame following an asset sale, compliance with the covenant should normally not be difficult.

of external leakage possibly deteriorating their financial position and thereby ensuring that certain procedural requirements are met in connection with sales of assets and subsidiary stock. As such, the restrictions of the covenant do not limit the amount of assets the Credit Group is permitted to sell; rather, the covenant governs the type of proceeds that may be received as consideration and defines appropriate uses for the proceeds from such sales. Under the covenant, a minimum percentage (typically between 75 percent and 85 percent) of the consideration from the sale must be cash or "deemed cash." To add flexibility, Issuers often request that this percentage is based on the aggregate consideration received on all asset sales since the date of the indenture.

While the definition of "deemed cash" is negotiated, it often includes (i) unsubordinated debt assumed by the buyer, so long as the Credit Group is unconditionally released, and (ii) cash equivalents that are converted into cash within a specified period of time (generally 90 to 180 days). Some indentures also permit "replacement assets" or long-term assets that are used or useful in the Issuer's business and equity in an entity that will become a Restricted Subsidiary as a type of "deemed cash."

The definition of "asset sales" is typically broadly defined and will generally include traditional asset disposals and any direct and indirect sales of interests in Restricted Subsidiaries, including any issue of new shares of a Restricted Subsidiary or any disposition by means of a merger, consolidation or similar transaction. Moreover, the definition will include categories of asset disposals that do not need to satisfy the asset sale test, such as:

- ordinary course transactions (such as sales of inventory in the ordinary course of business); and
- a carve-out for transactions below a specified minimum fair market value.

The asset sale test requires:

- the Issuer or the relevant Restricted Subsidiary to receive consideration equal to the fair market value of the assets sold;
- at least a minimum percentage (typically between 75 percent and 85 percent) of the consideration from the sale to be in the form of cash or "deemed cash"; and
- the Issuer or the relevant Restricted Subsidiary to apply the net cash proceeds from the asset sale within a specified period of time (usually 365 days) to acquire non-current assets or stock of another entity in the same business line that becomes a Restricted Subsidiary, to make capital expenditures and/or to repay "Senior Debt" (sometimes also requiring a permanent commitment reduction).

To the extent the net cash proceeds from an asset sale are not applied in accordance with the specified uses within the specified period of time, such net cash proceeds become "excess proceeds". When the aggregate amount of excess proceeds from all asset sales exceeds a specified dollar amount, the Issuer must use those excess proceeds to offer to repurchase, on a pro rata basis, the bonds at their face value, plus accrued interest and other *pari passu* debt that have similar repayment requirements.

Limitation on Affiliate Transactions

The purpose of the Limitation on Affiliate Transactions Covenant is to avoid leakage from the Credit Group to controlling stockholders and other affiliates. An affiliate is typically defined to include any person who controls, or is under common control with, the Issuer and usually includes any shareholder above a specified percentage (usually between 5 percent and 10 percent).

The covenant prohibits the Credit Group from entering into transactions with any affiliate unless:

- the transaction is on an arm's-length basis;
- if the transaction value exceeds a negotiated threshold amount, the transaction is approved by a majority of the Issuer's board of directors, including a majority of disinterested directors (although sometimes this approval is required only from an officer); and
- if the transaction value exceeds a higher threshold amount, the Issuer obtains a fairness opinion from an independent investment bank, accounting or appraisal firm (although often this approval is required only from the Issuer's board of directors).

Typical exemptions to the covenant include (i) transactions between and among the Issuer and its Restricted Subsidiaries, (ii) payment of reasonable and customary fees to directors, (iii) Restricted Payments made in accordance with the Limitation on Restricted Payments Covenant and Permitted Investments and (iv) payment of management fees to leveraged buyout sponsors.

LIMITATION ON DESIGNATION OF RESTRICTED AND UNRESTRICTED SUBSIDIARIES

The limitation on designation of Restricted Subsidiaries and Unrestricted Subsidiaries ensures that the various other covenants are not thwarted through the designation and redesignation of Restricted Subsidiaries and Unrestricted Subsidiaries.

As a general rule, all subsidiaries of the Issuer are Restricted Subsidiaries unless a subsidiary is listed as an Unrestricted Subsidiary in the indenture or the Issuer subsequently expressly designates a Restricted Subsidiary as an Unrestricted Subsidiary in accordance with the requirements of the indenture. The Issuer may designate and redesignate its subsidiaries as either Restricted Subsidiaries or Unrestricted Subsidiaries at any time, provided that, in order to designate a Restricted Subsidiary as an Unrestricted Subsidiary, the following conditions must be met:

- The Issuer must comply with the Limitation on Restricted Payments Covenant (i.e., the fair market value of the Issuer's deemed Investment in the relevant subsidiary at the time of designation must be permitted under the Restricted Payments covenant or as a Permitted Investment. Such Investment will be valued at the fair market value of the sum of the net assets of such subsidiary at the time of designation and the amount of any indebtedness of such subsidiary owed to the Issuer and any Restricted Subsidiary);

PRACTICE TIP

In the case of the acquisition of a new Subsidiary that the Issuer wants to immediately designate as an Unrestricted Subsidiary, there is a theoretical moment that the newly acquired Subsidiary is a Restricted Subsidiary prior to designation as an Unrestricted Subsidiary. This may present obstacles if the Restricted Subsidiary has existing debt or existing restricted investments, for example, in excess of that permitted by the indenture. To avoid this result, Issuers will want to provide in the indenture that a newly acquired Subsidiary that otherwise qualifies for immediate designation as an Unrestricted Subsidiary will be treated as being an Unrestricted Subsidiary from the moment it becomes a Subsidiary.

- The Issuer must comply with the Limitation on Indebtedness Covenant (i.e., any guarantee by the Issuer or the remaining Restricted Subsidiaries of any indebtedness of the Unrestricted Subsidiary will be deemed to be an incurrence of additional indebtedness). Typically, the Unrestricted Subsidiary may only incur "Nonrecourse Debt," which prohibits the Unrestricted Subsidiary from incurring any debt that is guaranteed or secured by the Issuer or any Restricted Subsidiary. In addition, the Issuer and its Restricted Subsidiaries are often prohibited from being the lenders of any debt to an Unrestricted Subsidiary;
- The newly Unrestricted Subsidiary must not hold capital stock or indebtedness of, or hold any liens on the assets of, or have any investment in, the Issuer and its remaining Restricted Subsidiaries;
- The Issuer must comply with the Limitation on Affiliate Transactions Covenant (i.e., any agreement, transaction or arrangement between the Issuer, the newly Unrestricted Subsidiary and the Issuer's remaining Restricted Subsidiaries must comply with the Limitation on Affiliate Transactions Covenant);
- The Issuer and its remaining Restricted Subsidiaries must not have any obligation to (i) subscribe for additional equity in the newly Unrestricted Subsidiary or (ii) maintain or preserve the financial condition of the newly Unrestricted Subsidiary (whether by guarantee or extension of credit); and
- The designation will not result in a default or an event of default.

In order to designate an Unrestricted Subsidiary as a Restricted Subsidiary, the following conditions must be met:

- The designation must be made in compliance with the Restricted Payments Covenant (i.e., any investment held by the newly Restricted Subsidiary must be able to be made in accordance with the Limitation on Restricted Payments Covenant or as a Permitted Investment);
- Any debt of the newly Restricted Subsidiary must be able to be made in accordance with the Limitation on Indebtedness Covenant;
- Any liens on the newly Restricted Subsidiary's assets must be in compliance with the Limitation on Liens Covenant; and
- The designation will not result in default or an event of default.

LIMITATION ON MERGER, CONSOLIDATION AND SALE OF SUBSTANTIALLY ALL ASSETS

The goal of the covenant in limiting mergers, consolidations and sales of substantially all assets (the "**Mergers Covenant**") is to prevent a business combination in which the resulting entity is not financially healthy, as measured by the Fixed Charge Coverage Ratio. The covenant prohibits the Issuer from merging with or consolidating into another entity, or transferring all or substantially all of the Credit Group's assets to another entity, unless the following general conditions are satisfied:

- Either the Issuer is the surviving entity or the surviving entity is an entity organized under the laws of a specified jurisdiction for U.S. domestic Issuers, the permitted jurisdiction will be a state of the United States or the District of Columbia and expressly assumes the Issuer's obligations under the bonds and the indenture;

- The Issuer or the surviving entity must be able to incur at least U.S.$1.00 of Ratio Debt under the Limitation on Indebtedness Covenant on a pro forma basis (although sometimes this condition requires only that the Issuer's Fixed Charge Coverage Ratio is no worse as a consequence of the transaction even if it still could not incur U.S.$1.00 of Ratio Debt); and
- The absence of default, either before or as a result of the transaction.
- As the covenant restricts certain transactions that may also constitute a change of control giving noteholders the option to put their bonds back to the Issuer, this covenant should be negotiated in conjunction with the Change of Control Covenant.

If the bonds are guaranteed by the Issuer's subsidiaries, then the Merger Covenant will also prohibit any Subsidiary Guarantor from merging with or consolidating into another entity, or transferring all or substantially all of the Subsidiary Guarantor's assets to another entity, unless the following general conditions are satisfied:

Either:

- (A) (i) the transaction will result in the Subsidiary Guarantor no longer being a subsidiary of the Issuer, (ii) the transaction complies with the Limitation of Asset Sales Covenant and (iii) the Subsidiary Guarantor is released from its guarantee of the bonds in accordance with the terms of the indenture; or
- (B) (i) either the Subsidiary Guarantor is the surviving entity or the surviving entity is an entity organized under the laws of a specified jurisdiction and expressly assumes the Subsidiary Guarantor's obligations under its bonds guarantee and (ii) the absence of any default under the indenture, either before or as a result of the transaction.

CHANGE OF CONTROL

The Change of Control Covenant protects noteholders from fundamental changes in the Issuer's ownership structure and/or board composition. Investors have traditionally insisted on a change of control put option because the identity, track record and financial and business strategies of the Issuer's ultimate owners can be a significant factor in investors' overall investment decisions. This can be particularly true for portfolio companies of private equity sponsors that are repeat players in the high-yield markets.

Upon the occurrence of any of a series of specified change of control events, the Issuer is required to make an offer (i.e., a change of control offer) to repurchase the bonds at a specific percentage (usually 101 percent) of their principal amount. Specific change of control events can be heavily negotiated between the Issuer and the underwriters (especially where an initial public offering ("**IPO**") or partial sale of the Issuer within the terms of the bonds are realistic scenarios) but will ordinarily include:

- the acquisition by a person or group of people (other than defined permitted equity holders) of more than a specific percentage (generally between 30 percent and 50 percent) of the Issuer's voting capital;
- a contested change in the Issuer's board of directors (e.g., from a proxy fight); and
- dispositions of all or substantially all of the Credit Group's assets.

REPORTING REQUIREMENTS

The purpose of the reporting covenant is to ensure the continuous availability of current information on the Issuer's financial performance. While it may appear to be a boilerplate covenant, potential investors can be very sensitive about the content of this covenant and generally require the Issuer to provide full public disclosure for as long as the bonds are outstanding, whether or not the Issuer is subject to SEC or other reporting requirements. Public availability of current information on the Issuer's financial performance is important not only for the development of a liquid market in the bonds, but it also protects noteholders that may wish to sell their bonds from potential liability for market abuse. Additionally, the availability of current information on the Issuer's financial performance is necessary to permit U.S. investors to resell their bonds within the United States in reliance on Rule 144A. See "*Legal Considerations – Transaction Structure and Federal Securities Law – Rule 144A*."

Legal Considerations

Transaction Structure and Federal Securities Law

The terms and restrictive covenants of high-yield bonds are set forth in an indenture, which is typically governed by New York law. Pursuant to the indenture, a trustee is appointed to represent the interests of noteholders. Extensive New York case law provides both the Issuer and the noteholders with a relative degree of certainty regarding the interpretation of the high-yield covenants and legal issues associated with the bonds and the indenture.

Section 5 of the Securities Act of 1933, as amended (the "**Securities Act**"), prohibits the offer and sale of securities to any person unless a registration statement (including a prospectus that meets statutory requirements) has been filed with the Securities and Exchange Commission ("**SEC**") and become effective or unless an exemption from such registration is available. Substantially all high-yield bond offerings are conducted as private placements (i) in the United States through a combination of Section 4(a)(2) of the Securities Act and Rule 144A under the Securities Act ("**Rule 144A**") and (ii) outside of the United States in reliance on Regulation S under the Securities Act ("**Regulation S**"). This is generally true whether the Issuer is private or already a public reporting company, largely due to the fact that registration involves delays and the target market for high-yield bonds is principally mutual funds, insurance companies, pension funds, hedge funds and other large financial organizations that qualify as qualified institutional buyers ("**QIBs**") as to which the availability of Rule 144A mitigates the negatives typically associated with holding "restricted securities."[2]

2 For a variety of reasons, including the relative simplicity and flexibility of a private placement followed by a subsequent A/B exchange offer (discussed below), high-yield debt offerings are infrequently done "off the shelf" (i.e., utilizing a shelf registration statement that

SECTION 4(A)(2)

The first step in the bond offering is the sale of the bonds from the Issuer to the initial purchasers (i.e., the underwriters) through a private placement of the bonds under Section 4(a)(2) of the Securities Act, which exempts transactions by an Issuer not involving a public offering. Immediately following the sale of the bonds to the initial purchasers, the initial purchasers resell the bonds to QIBs under Rule 144A and to persons outside the United States under Regulation S.

RULE 144A

Rule 144A provides a safe harbor that permits resales of securities only to QIBs. QIBs include various enumerated categories of sophisticated institutional investors with at least $100 million of securities of non-affiliates under management, banks or savings and loan associations that own and invest at least $100 million of securities of non-affiliates and that have an audited net worth of at least $25 million, as well as SEC-registered broker-dealers owning and investing at least $10 million in securities of non-affiliates. In addition, to be eligible for the Rule 144A safe harbor, purchasers must be notified that a proposed sale is being made pursuant to Rule 144A (typically by way of appropriate legends and disclaimers in the offering memorandum) and the relevant securities must (i) not be of the same class as securities listed on a national stock exchange or quoted on an automated inter-dealer quotation system (e.g., NASDAQ), (ii) not be convertible or exchangeable into listed or quoted securities with an effective premium of less than 10 percent and (iii) not be issued by an open-end investment company.

Holders of the relevant securities and prospective purchasers must have the right to obtain from the Issuer certain reasonably current information about the Issuer. Because resales of securities pursuant to Rule 144A (like any other offers and sales of securities in the United States) are subject to the liability and anti-fraud provisions under the U.S. securities laws (including Rule 10b-5 under the U.S. Securities Exchange Act of 1934, as amended (the "**Exchange Act**")), it is market practice to provide disclosure in connection with a Rule 144A offering that is substantially similar to the disclosure required for an SEC-registered offering, both in terms of quality and scope. Accordingly, the due diligence exercises conducted by the working group in a Rule 144A transaction are comprehensive and robust and very similar to due diligence that would be conducted by the working group in a registered offering. See "*Documentation – Legal Opinions and Disclosure Letters*."

REGULATION S

Regulation S provides a safe harbor from the registration requirements of Section 5 of the Securities Act for certain offerings outside the United States and offshore resales of securities. If the conditions of Regulation S are met, the transaction is deemed to take place outside of the United States and does not trigger the registration requirements of Section 5 of the Securities Act.

has been previously filed with, and declared effective by, the SEC.)

Under Regulation S, an offer or sale of securities is deemed to occur outside the United States if (i) the offer or sale is made in offshore transactions and (ii) no directed selling efforts are made in the United States by the Issuer, the underwriters, any other distributor, any of their respective affiliates or any person acting on their behalf.

An offshore transaction is defined as an offer that is not made to a person (which includes entities) in the United States and either:

- at the time the buy order is originated, the buyer is outside the United States or the seller and any person on the seller's behalf reasonably believes that the buyer is outside the United States;
- the transaction is executed in, on or through the physical trading floor of an established foreign securities exchange located outside of the United States (for Issuer safe harbor); or
- the transaction is executed in, on or through the facilities of a designated offshore securities market and neither the seller nor any person on the seller's behalf knows the transaction has been prearranged with a buyer in the United States (for resale safe harbor).

Directed selling efforts means any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the U.S. market for any of the securities being offered in reliance on Regulation S. It is therefore necessary for the counsel involved in an offering to analyze any relevant activity or communication in terms of its audience, timing and content as well as in light of both the various exceptions included in the definition of directed selling efforts and the relevant SEC staff positions.

In order to qualify for a given safe harbor under Regulation S, certain additional requirements, such as the implementation of additional offering restrictions and the imposition of a distribution compliance period, may have to be met as well. These requirements vary depending principally on the status of the Issuer and the likelihood of the bonds issued outside of the United States pursuant to Regulations S flowing back into the U.S. market. The three categories of requirements under Regulation S are:

- Category 1 (least restrictive) – it is unlikely that securities offered abroad will flow into the U.S. market and no other requirements need to be met other than the Regulation S basic conditions;
- Category 2 – adequate information about the Issuer is publicly available in the United States, such that the concerns about securities flowing into the U.S. market are reduced. Offering restrictions must be adopted, including that no offers or sales may be made to a U.S. person or for the account or benefit of a U.S. person during a 40-day distribution compliance period; and
- Category 3 (most restrictive) – adequate information about the Issuer is not publicly available in the United States and existing potential U.S. market interest is sufficient (i.e., there is substantial U.S. market interest with respect to the relevant securities) to suggest that offerings of the Issuer's securities outside the United States may not come to rest abroad. All of the category 2 restrictions

must be adopted (with further distribution compliance period restrictions), and certain purchaser certifications and others restrictions must be satisfied.

Registered Exchange Offers Versus Private-for-Life

The initial private placement of the bonds and subsequent resale pursuant to Rule 144A or Regulation S result in the noteholders holding restricted securities. However, holding restricted securities is problematic for a subset of investors who are not permitted to hold unlimited amounts of restricted debt securities, due to internal policies, provisions in operating agreements or regulatory restrictions. Restricted securities held by non-affiliates of the Issuer are generally subject to a six-month holding period for Issuers subject to Exchange Act reporting requirements or a one-year holding period for non-reporting Issuers before the restricted securities may be resold without restriction pursuant to Rule 144 of the Securities Act. However, the noteholders may sell the bonds prior to meeting the Rule 144 holding period requirements to other QIBs pursuant to Rule 144A and to foreign investors under Regulation S.

Historically, with a view to broadening the marketing and distribution of the bonds to as many eligible investors as possible, it is commonplace for Issuers of high-yield bonds to enter into a registration rights agreement with the initial purchasers of the bonds at the closing of the offering in which the Issuer agrees to engage in what is known as an "A/B exchange offer" within a certain time period after the issuance of the bonds. Pursuant to guidance provided by the SEC in certain no-action letters (including the Exxon Capital no-action letter in which the SEC initially approved the procedure), an A/B exchange allows the Issuer to exchange debt securities initially issued in a private placement for identical new securities in an offering registered with the SEC. The registration rights agreement will require the Issuer to file a registration statement (on Form S-4) for the A/B exchange within a certain period of time following the issuance of the original bonds and to have the registration statement declared effective by the SEC within an additional number of days or otherwise be subject to penalties in the form of additional interest until the SEC declares the registration statement effective. The time period to conduct the exchange offer varies greatly (from 120 days to 365 days, depending on the nature of the Issuer). Payments of additional interest typically continue until the earlier of the exchange offer or an outside date (which varies depending on the time period allowed for consummating the exchange).

The exchange offer registration statement will be virtually identical to the offering memorandum but updated accordingly for the passage of time and describing the mechanics of the A/B exchange offer and related issues. The SEC may review and comment on the registration statement and often will for first-time registrants. If the Issuer is not already a public company, the A/B exchange offer will also be attractive to investors because as a consequence of issuing registered bonds, the Issuer will become subject to SEC rules and regulations, including the requirement to file periodic and current reports (i.e., Forms 10-K, 10-Q and 8-K), thus ensuring a steady

PRACTICE TIP

It is important to determine with the initial purchasers as early as possible whether a transaction will be structured as a Rule 144A offering only or Rule 144A/ Regulation S offering as this will impact the due diligence and disclosure requirements, among other things, and the overall transaction timeline.

flow of financial and other information mandated by the SEC to the holders of the bonds and the investing public. Companies that are not public must balance these marketing benefits against the additional cost of becoming a public company, including increased reporting requirements and liability, as well as any negative effects that being a public reporting company by virtue of a registered debt offering may have on the company's future plans, such as an initial public offering of equity securities (i.e., a traditional IPO). Weighing these factors, private companies often elect to issue the bonds as "private-for-life" or "144A-for-life," that is, without any registration rights or other requirement that the Issuer become a reporting company.

The registration rights agreement that evidences the obligation of the Issuer to engage in the A/B exchange also generally requires that the Issuer file a shelf registration statement to permit SEC-registered resales of the bonds under certain circumstances, such as if the exchange offer cannot be consummated due to a change in law or SEC policy or if a bondholder isn't eligible to participate in the exchange offer because it is an affiliate of the Issuer.

A further consideration for both public and private companies is the applicability of the Trust Indenture Act of 1939 ("**TIA**"). The purpose of the TIA is to protect noteholders and to curb perceived abuses by companies and underwriters in issuing debt securities. Debt securities issued in private placements exempt from registration under Section 4(a)(2) of the Securities Act are not subject to the TIA; however, bonds that are registered, including bonds that are issued in an A/B exchange offer, are subject to the TIA. The TIA contains numerous requirements applicable to trustees, Issuers and the terms of the indenture that governs the bonds. In particular, in the case of secured bonds, the TIA has certificate and opinion requirements applicable to releases of collateral that can be cumbersome and expensive, particularly for first-lien secured bonds.[3]

More recently, the operation of Section 316(b) of the TIA has been called into question by several decisions out of New York. Section 316(b) requires the consent of each holder when seeking to impair or adversely affect the right of such holder to receive payment of principal or interest. Previously, Section 316(b) was thought to protect against only involuntary modification of payment terms or a noteholder's right to sue for payment; however, in recent decisions, New York courts, looking to legislative history, have expanded the provision to also protect against actions by the Issuer, whether or not involving a modification of the terms of the bond or the indenture, that might lead to the holders of the bonds receiving a lesser payment than was originally bargained, at least outside of a court supervised restructuring. Uncertainty associated with the proper application and interpretation of these decisions has led to an increase in private-for-life bond offerings, as well as modifications to the relevant provisions of indentures used in these offerings.

3 The SEC has granted no action relief in the case of bonds secured by second priority (or lower) liens that lessens the compliance burden of such provisions.

Publicity Restrictions

United States securities laws impose various restrictions on publicity and the release of information generally in connection with a proposed offering of securities. Publicity for this purpose can be construed very broadly and may include any form of communication, whether in written, oral or electronic form, that (i) relates to or concerns the offering, (ii) relates to the performance, assets, liabilities, financial position, revenues, profits, losses, trading record, prospects, valuation or market position of the Issuer, (iii) might affect an investor's assessment of the financial position and prospects of the Issuer or (iv) otherwise has the purpose, or reasonably could have the effect, of conditioning the market in a particular jurisdiction or influencing or encouraging an investor's interest in the Issuer, the offering or a decision to purchase the securities in question.

The release of information that is inaccurate, misleading or inconsistent with the offering memorandum is undesirable, as it may cast doubt on the accuracy of the offering memorandum. Failure to observe publicity requirements may result in registration or similar requirements under the securities laws and imposition of a cooling-off period and may result in the offering not being completed. As such, careful attention to publicity is imperative to the successful and timely completion of an offering. A common problem is information on the Issuer's website. Therefore, the Issuer's website should be scrubbed before the deal to remove all information that is inaccurate, misleading or inconsistent with the offering memorandum. Additionally, the Issuer should avoid posting information on its website during the course of the offering.

To ensure compliance with all applicable securities laws and regulations, the Issuer's counsel will typically prepare publicity guidelines at the outset of a proposed offering. The guidelines may be reviewed by the underwriters' counsel and must be adhered to by all offering participants. While all Issuer representatives and other offering participants that are likely to be approached by, or come in contact with, the press or securities analysts during the course of the offering should be familiar with the publicity guidelines, it is advisable to appoint one Issuer representative to serve as the initial point of contact with the press and securities analysts and to handle publicity and other broad-based communications during the offering process.

PRACTICE TIP

Publicity restrictions should be implemented very early in the process and in most cases should be in place shortly after the transaction kicks off.

Transaction Execution

Pre-launch

Under ideal circumstances and with the full commitment of all parties involved in the offering, the preparations for a high-yield bond offering for a first-time Issuer can be completed within approximately six to ten weeks from the initial kick-off meeting to the offering launch (i.e., the formal external announcement of the proposed offering). Factors that cause delays include: (i) the lack of existing, high-quality disclosure language regarding the Issuer and its business that can be tailored for purposes of the offering memorandum, (ii) the time needed by Issuer's internal accounting team and external auditors to prepare the required financial information, (iii) complications and delays in any necessary negotiations with existing creditors of the Issuer, (iv) complexities involved in releasing existing security interests (in favor of creditors that are being repaid) and in creating new security interests (in favor of the noteholders), (v) delays and complications in the rating process and (vi) general market conditions.

The table on the next page details a typical pre-launch timeline:

TIME	PRE-LAUNCH TASKS
WEEK 1	• Issuer's counsel prepares initial offering memorandum outline and discusses it with Issuer.
	• Issuer, initial purchasers and their respective counsels agree to offering structure.
	• Issuer and Issuer's counsel discuss covenant package.
	• Issuer's counsel discusses covenant concerns with initial purchasers' counsel.
	• Issuer prepares data room in response to due diligence request list provided by Issuer's counsel and initial purchasers' counsel.
	• Initial purchasers circulate management due diligence questionnaire.
	• Issuer's counsel circulates publicity guidelines.
	• Initial purchasers' counsel circulates research guidelines.
WEEK 2	• Issuer circulates management presentation to working group.
	• Issuer, initial purchasers and their respective counsels agree to approach with respect to existing lenders and security trustee.
	• Working group provides feedback on draft offering memorandum.
	• Issuer and Issuer's counsel revise draft offering memorandum.
	• Issuer's counsel and initial purchasers' counsel commence documentary due diligence.
	• Initial purchasers and initial purchasers' counsel draft description of the notes, terms and conditions, and note documentation.
WEEK 3	• Select trustee and trustee's counsel.
	• Issuer's counsel recirculates draft offering memorandum.
	• Initial purchasers' counsel circulates draft description of the notes.
	• Draft documentation for trustee accession arrangements to existing security (if applicable).
	• Initial purchasers and initial purchasers' counsel review draft offering memorandum and prepare consolidated markup.
	• Issuer and Issuer's counsel discuss description of the notes.
	• Drafting session on draft offering memorandum.
	• Draft accountant engagement and comfort letters circulated.
	• Initial purchasers and initial purchasers' counsel circulate draft purchase agreement.
	• Issuer and initial purchasers prepare ratings agency presentation.
	• Issuers, initial purchasers and their respective counsels further discuss approach with respect to existing lenders and security trustee, if necessary.
WEEK 4	• Issuer's counsel recirculates draft offering memorandum.
	• Issuer's counsel circulates markup of description of the notes.
	• Initial purchasers and initial purchasers' counsel review draft offering memorandum and prepare consolidated markup.
	• Initial purchasers, Issuer and their respective counsels discuss description of the notes.
	• Drafting session on draft offering memorandum.
	• Issuer and Issuer's counsel discuss purchase agreement and registration rights agreement and circulate markup to initial purchasers and initial purchasers' counsel.
	• Issuer and initial purchasers prepare ratings agency presentation.
WEEK 5	• Drafting session on draft offering memorandum, if necessary.
	• Discussions on description of the notes (including with trustee and trustee's counsel) and trustee note accession arrangements.
	• Discuss purchase agreement and registration rights agreement, if necessary.
	• Issuer and initial purchasers prepare ratings agency presentation.
	• Work on roadshow presentation.
WEEK 6	• Issuer submits draft offering memorandum to printer with final description of the notes.
	• Drafting session on draft offering memorandum, if necessary, to finalize preliminary offering memorandum.
	• Discuss and finalize purchase agreement and registration rights agreement, if necessary.
	• Meetings with ratings agencies and feedback.
	• Finalize roadshow presentation.
	• Print preliminary offering memorandum.

Post-launch

To market and build momentum for the offering, the Issuer and the initial purchasers go on a roadshow (the length of which varies from a few days up to two weeks) after launch. During this time, the other members of the working group finalize the bond rating and contractual documentation. Repeat Issuers may only conduct an electronic roadshow or conduct the offering on an "overnight" basis without conducting a roadshow at all.

Following completion of the roadshow, all parties participate in a bring-down due diligence call with the Issuer's management, the Issuer's auditors deliver the comfort letter, and the Issuer and the initial purchasers hold the pricing meeting during which the offering terms are set. See "*Documentation – Comfort Letter.*" After the pricing meeting, the Issuer, any guarantors and the initial purchasers execute the purchase agreement, at which point the Issuer and the initial purchasers are bound to complete the offering, subject to certain closing conditions. The Issuer's counsel and the initial purchasers' counsel then prepare the final offering memorandum and closing documents in preparation for closing. Upon closing, which usually takes place three business days after the pricing date (T+3), the bonds are formally issued and delivered by the Issuer against payment therefor by the initial purchasers.

Documentation

OFFERING MEMORANDUM

The offering memorandum is a disclosure document intended to provide potential investors with all material information necessary to make informed investment decisions and contains information similar to the information set forth in a prospectus for a public offering. In addition to providing potential investors with information about the proposed offering, the offering memorandum serves to protect both the Issuer and the initial purchasers from liability under applicable securities laws for alleged material misstatements or omissions in connection with the offer and sale of the bonds.

The key disclosure items in the offering memorandum are:

Offering Summary or "Box." The initial purchasers and potential investors focus on the Box, which has a marketing focus and provides (i) an issuance overview, (ii) a business description (including business strategies and competitive strengths), (iii) the corporate and transaction structure and (iv) summary financial data.

Risk Factors. The risk factors section specifies the risks associated with the Issuer and its industry and risks related to the bonds and the private placement. The risk factors are often similar to risk factors found in offering memoranda and prospectuses of other Issuers in the same industry and tailored to describe the specific risks associated with the company conducting the present offering. Risk factors should not contain any mitigating language with respect to the particular risk being described.

Use of Proceeds. The use of proceeds section summarizes the sources and uses of the funds being raised by the offering, as well as any other sources of capital.

Capitalization. The capitalization section sets forth the Issuer's actual and pro forma capitalization to reflect the proceeds raised in the offering and application of the net proceeds.

Financial Statements. The Issuer is required to include audited and reviewed financial statements (prepared in accordance with generally accepted accounting principles), including a balance sheet (typically the end of the two most recent fiscal years and most recent interim period) and statements of income, cash flows and stockholders' equity (typically the three most recent fiscal years and most recent interim period and comparable prior year interim period). The Issuer will also include selected financial data for the past five years in the offering memorandum.

The preparation and audit of financial statements will require a significant amount of time, particularly for Issuers that are not subject to the reporting requirements of the Exchange Act or that have not presented audited financial statements in the past. An Issuer that does not have current audited financial statements should start the process as early in the preparation period as possible. Described below are additional aspects related to the Issuer's financial statement presentation that Issuers should be aware of and consider at the outset of an offering.

Rule 3-05 of Regulation S-X requires the Issuer to provide separate financial statements of companies the Issuer has acquired or that it is probable that the Issuer will acquire if the acquired company meets any of the three significance tests:

i. The "income test" compares the Issuer's equity in the target's income from continuing operations before taxes, extraordinary items and cumulative effect of a change in accounting principle to such income of the Issuer for the most recently completed fiscal year;

ii. The "investment test" compares the GAAP purchase price of the target to the Issuer's consolidated assets as of the end of the most recently completed fiscal year; and

iii. The "asset test" compares the Issuer's share of the total assets of the acquired business to the Issuer's consolidated total assets.

If none of the significance tests exceed 20 percent, no financial statements for the acquired company are required. If any of the tests are (i) between 20 percent and 40 percent, then the Issuer will be required to provide financial statements of the acquired company for the most recent completed fiscal year and subsequent interim period; (ii) between 40 percent and 50 percent, then the Issuer must provide financial statements for the two most recent fiscal years and subsequent interim period; and (iii) over 50 percent, then the Issuer must provide financial statements for the three most recent fiscal years and subsequent interim period.

PRACTICE TIP

Determination by the working group (i.e., auditors, underwriters, Issuer and counsels) of the financial statements to be included in the offering memorandum should be made as early as possible so that the scope of due diligence and disclosure and comfort letter deliverables are clear to all parties and can be managed appropriately to meet the targeted timeline.

Additionally, Article 11 of Regulation S-X requires that the Issuer provide separate pro forma financial statements in the event a significant acquisition has occurred during the current fiscal year or is probable to occur. The pro forma presentation provides investors with the financial information of the combined company as if the acquisition had occurred at the beginning of the applicable period and shows the impact of the transaction on the Issuer's financial statements. The pro forma financial statements will include a pro forma balance sheet as of the end of the most recent period required by Rule 3-01 of Regulation S-X and a pro forma income statement for the most recent fiscal year and the most recent interim period.

In addition, Rule 3-10 of Regulation S-X requires that the Issuer provide separate financial statements for each subsidiary of the Issuer that is a guarantor of the bonds unless (i) the subsidiary is wholly owned by the Issuer, (ii) the guarantees are joint and several, (iii) the guarantees are full and unconditional and (iv) the Issuer's financial statements contain a footnote that includes condensed consolidating financial information with a separate column for the parent company, the subsidiary guarantors on a combined basis, any other subsidiaries of the Issuer on a combined basis, consolidating adjustments and the total consolidated amounts. Rule 3-10 contains a similar rule for an Issuer that is a finance subsidiary that is issuing bonds guaranteed by its parent company, which also provides exceptions that are similar to the exceptions applicable to subsidiary guarantors.

Rule 3-16 of Regulation S-X requires that the Issuer provide separate audited and interim financial statements for any affiliate of the Issuer if the Issuer is issuing registered bonds that are secured by securities of the affiliate and the securities being pledged constitute a substantial portion of the collateral that secures the registered bonds that are issued. The securities will be deemed to constitute a substantial portion of the collateral if the aggregate amount of the securities is 20 percent or more of the collateral securing the bonds. Rule 3-16 will apply to both registered securities, as well as any unregistered securities with registration rights. While Rule 3-16 should be considered, secured high-yield offerings that fall into this category are not typical.

Management's Discussion and Analysis (MD&A). The MD&A section details the Issuer's financial performance through the eyes of the Issuer's management team from both a historical perspective and the Issuer's future expectations. The MD&A discussion will analyze and discuss the Issuer's financial performance on a period-by-period comparison basis and explain the reasons for differing results, as well as performance trends. The Issuer will also discuss its liquidity and capital resources, including the Issuer's expected use of the funds being raised in the high-yield offering. The MD&A should also discuss the Issuer's exposure to risks associated with the marketplace in general and commodity prices and interest rate risks.

Business. This section discusses the Issuer's business, its industry and related competition, its strategies and strengths, its operations, and its products and services, as well as other areas that are specific to the Issuer's business.

Management. The management section sets forth specific information regarding each of the Issuer's directors and key management members, including compensation matters, individual experience and education, as well as any related party transactions between the Issuer and its officers, directors and significant stockholders.

Description of Other Indebtedness. This section provides an overview of the Issuer's existing debt, including its credit facilities and other indebtedness.

Description of the Notes (DoN). The DoN discusses the specific terms and conditions of the notes and summarizes the indenture. For a more detailed discussion of the DoN, see "*General Observations*" and "*The High-Yield Bond Covenant Package.*"

Other Sections. The offering memorandum will include other sections, such as the plan of distribution, restrictions on transfer, material tax considerations, outside experts or advisors, etc. In addition, certain industries, such as oil and gas, banking and real estate, may require another level of industry-specific disclosure as set out under specific SEC disclosure guides. Expert reports may also be included in the offering memorandum.

INDENTURE

The indenture is the contract entered into among the Issuer, any guarantors and the trustee (an agent acting on behalf of the noteholders). It includes all of the terms of the bonds, including interest rate and maturity date and all of the bond covenants. The terms of the indenture are summarized in the description of the notes section of the offering memorandum.

PURCHASE AGREEMENT

The purchase agreement is the contract between the Issuer and the initial purchasers, whereby the Issuer agrees to issue and sell the bonds to the initial purchasers, and the initial purchasers agree, subject to certain conditions, to purchase the bonds from the Issuer, at an agreed price at closing. Additionally, in the purchase agreement, the Issuer makes numerous representations and warranties, including with respect to its business and the completeness and accuracy of the offering memorandum, and agrees to indemnify the initial purchasers for any losses arising from material misstatements or omissions in the disclosure in the offering memorandum.

INTERCREDITOR AGREEMENT

The intercreditor agreement governs the common terms and relationships among the creditors with respect to the Issuer's obligations. The parties to the intercreditor agreement include the main secured creditors of the Issuer. The agreement contains provisions limiting the ability of creditors to vary their respective rights and addresses such issues as voting rights, notifications of defaults and the order of applying proceeds of any debt recovery efforts (including from the sale of collateral). To the extent certain groups of creditors are subordinated to other groups of creditors, the intercreditor agreement sets forth the terms of subordination and other principles to apply. See "*Subordination – Lien Subordination*."

LEGAL OPINIONS AND DISCLOSURE LETTERS

At closing, both the Issuer's and the initial purchasers' counsels provide the initial purchasers with opinions with respect to certain legal matters and formal disclosure letters (referred to as negative assurance letters or Rule 10b-5 letters). The Rule 10b-5 letters indicate that, in connection with counsels' work on the offering and as a result of their own investigations, nothing causes the counsels to believe that the offering memorandum contains a material misstatement or omission. These letters are the culmination of counsels' comprehensive due diligence of the Issuer during the course of the transaction and satisfaction that the offering memorandum disclosure is in line with the federal securities law anti-fraud provisions under Section 10b and Rule 10b-5 of the Exchange Act. The Rule 10b-5 letter is typically a requirement for the initial purchasers for any Rule 144A high-yield bond offering.

COMFORT LETTERS

The comfort letter is issued by the Issuer's auditors at pricing and is addressed to the initial purchasers. In the comfort letter, the auditors (i) reaffirm their independence, (ii) state that they stand by their audit opinion on the Issuer's audited financial statements included in the offering memorandum, (iii) describe any procedures they have performed on any interim financial information included in the offering memorandum or on any internal management accounts for the period of time between the date of the Issuer's latest audited or reviewed financial statements and the date of the offering memorandum (referred to as a "**Stub Period**"), (iv) describe any additional agreed-upon procedures they conducted with respect to the Issuer's financial information included in the offering memorandum and (v) provide negative assurance as to the absence of material changes with respect to certain specified financial line items during the Stub Period. The Issuer's auditors will provide a bring-down comfort letter, as of the closing date, to verify that the original comfort letter is still valid.

Key Members of Our Global High-Yield Practice

AMERICAS

GEORGE BAPTISTA
New York
+1 212 506 2375
george.baptista@mayerbrown.com

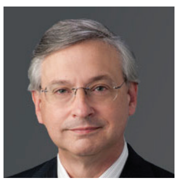
HARRY R. BEAUDRY
Houston
+1 713 238 2635
hbeaudry@mayerbrown.com

JOHN BERKERY
New York
+1 212 506 2552
jberkery@mayerbrown.com

EDDIE BEST
New York
+1 212 506 2133
ebest@mayerbrown.com

JENNIFER CARLSON
Palo Alto
+1 650 331 2065
jennifer.carlson@mayerbrown.com

JEFFREY M. DOBBS
Houston
+1 713 238 2697
jdobbs@mayerbrown.com



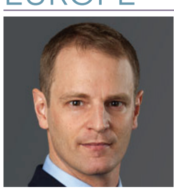
BILL HART JR.
Houston
+1 713 238 2603
bhart@mayerbrown.com

WILLIAM T. HELLER IV
Houston
+1 713 238 2684
wheller@mayerbrown.com

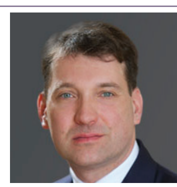
JODI SIMALA
Chicago
+1 312 701 7920
jsimala@mayerbrown.com

KIRK TUCKER
Houston
+1 713 238 2500
ktucker@mayerbrown.com

EUROPE

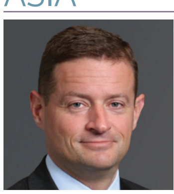


BERND BOHR
London/New York
London +44 20 3130 3640
New York +1 212 506 2299
bbohr@mayerbrown.com

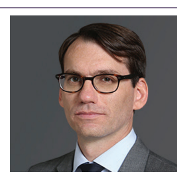


ROBERT FLANIGAN
London/Paris
London +44 20 3130 3488
Paris + 33 1 53 53 43 43
rflanigan@mayerbrown.com

ASIA



JASON THOMAS ELDER
Hong Kong
+852 2843 2394
jason.elder@mayerbrownjsm.com



THOMAS KOLLAR
Hong Kong
+852 2843 4260
thomas.kollar@mayerbrownjsm.com

About Mayer Brown

Mayer Brown is a global legal services organization advising clients across the Americas, Asia, Europe and the Middle East. Our presence in the world's leading markets enables us to offer clients access to local market knowledge combined with global reach.

We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, CAC 40, DAX, Hang Seng and Nikkei index companies and more than half of the world's largest banks. We provide legal services in areas such as banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; U.S. Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory and enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

Please visit www.mayerbrown.com for comprehensive contact information for all Mayer Brown offices.