MAYER | BROWN

High Yield Bonds

Covenant Packages Tailored to Suit

The Complete Issuer's Guide

U.S. Edition

Contents

OUR CAPITAL MARKETS PRACTICE

Mayer Brown is one of the leading securities and capital markets law firms in the world, advising issuers, underwriters and agents in domestic and international private and public financings.

Our practice is diverse, spanning the financing continuum of private placements, Rule 144A and Regulation S offerings, initial public offerings and continuous issuance programs, such as medium-term note and commercial paper programs. We also cover the full range of securities products – from simple common equity to complex convertible and high-yield bonds, derivatives, structured products and securitization transactions.

Our lawyers have years of experience advising issuers and underwriters on high yield bond offerings in numerous jurisdictions. Our high-yield lawyers work closely with lawyers in our market-leading banking, structured finance, restructuring and broader debt capital markets practices and can handle all aspects of high-yield debt offerings, including negotiating complex covenant packages, handling subordination, security and intercreditor issues and advising on bridge-to-bond financings, bank-to-bond financings and restructurings and structuring and negotiating complex leveraged buy-outs.

While we have exceptional credentials in many areas, we consider one of our greatest strengths to be our global network, and our ability to marshal our resources and bring them to bear on complex cross-border transactions—joining together with a shared commitment to deliver practical and timely advice.

High-Yield in Context

High-Yield Bonds Compared to Traditional Bank Financing

High-yield bonds (or notes) provide companies with the benefits associated with long-term debt financing but with covenants that are typically less onerous than standard credit facility covenants. The high-yield bond covenant package is self-administered, rather than requiring an ongoing dialogue with creditors or regular inspections by a bank lender.

In addition, the high-yield bond covenant package generally does not include traditional bank financing maintenance covenants, which require the borrower to maintain a certain level of financial health by satisfying specified financial metrics or permit lenders to call or accelerate the loans. Instead, high-yield covenants are incurrence covenants, which are evaluated only when the Issuer or any of its Restricted Subsidiaries undertakes some specified action, such as incurring indebtedness, paying a dividend or making an investment. The high-yield covenant package rewards positive financial performance with additional flexibility. While poor financial performance will result in reduced flexibility to protect investors, it alone will not trigger a default under the indenture or cause an acceleration of the high-yield bonds.

While typically less onerous than standard credit facility covenants, high-yield covenants can nonetheless be quite complex. Any company looking to access the high-yield capital markets is well-advised to retain experienced counsel to guide it in tailoring the covenant package. Proper tailoring will provide the Issuer sufficient flexibility to operate and grow its business, while at the same time, protecting the interests of investors to ensure successful execution of the bond offering.

Traditional Bank Loan	***High-Yield Bonds***
Maintenance and incurrence covenants	Incurrence covenants only
Typical term of three to five years	Typical term of five to ten years
Interim principal payments	Bullet maturity
Repayable at any time	Non-call period of three to five years and thereafter decreasing prepayment/call premium. Typical call features: 5nc2, 7nc3, 8nc4 and 10nc5. During the "non-call period," Issuers are often permitted to call the bonds, but with a "make-whole" premium (essentially the present value of all remaining interest and principal payments based on a discount rate of U.S. treasuries *plus* a spread (typically 50 bps))
Amendments relatively common and uncomplicated, except in syndicated context in which there may be numerous lenders	Amendments require consent solicitation from bondholders, which can be costly and time-consuming
Senior and typically secured and guaranteed	Potentially more flexibility; senior or subordinated, although even senior high-yield bonds often are effectively subordinated to the Issuer's credit facility through either structural or lien subordination; frequently unsecured
Minimal public market awareness	Awareness in public capital markets and may serve as a benchmark to facilitate further fundraisings, including an initial public offering or subsequent debt offerings
Rating not required	Rating required (typically by two agencies among Fitch, Moody's and S&P)
Investors are typically banks and institutional funds	Investors are typically mutual funds, hedge funds, insurance companies, pension funds and private wealth management accounts
No securities law liability, but potential ongoing records requirements and inspection rights afforded to bank lenders	Potential disclosure liability related to the offering memorandum, but no inspection or access rights for bondholders

As a whole, the high-yield covenant package is designed to achieve three primary objectives:

1. Prevent the **Credit Group** (consisting of the Issuer, any Guarantors and all Restricted Subsidiaries) from becoming over-leveraged by either incurring too much debt or decreasing the Credit Group's cash-generating assets without concurrently decreasing debt;
2. Protect the position of bondholders 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
3. 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 members of Credit Group to:

- incur debt or guarantee debt incurred by others;
- make "restricted payments" that result in value leakage out of the Credit Group, including: (i) paying dividends on, or repurchasing, capital stock of the Issuer; (ii) making investments in entities outside the Credit Group; and (iii) repaying subordinated debt prior to its stated maturity;
- grant liens on their assets to secure other indebtedness;
- sell assets outside the ordinary course, including the capital stock of subsidiaries;
- enter into or engage in transactions with affiliates outside the Credit Group;
- engage in mergers or consolidations or sell substantially all of the Issuer's or a Guarantor's assets;
- enter into new types of business activities;
- 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, (ii) private companies looking to reorganize their capital structures or (iii) companies that are the targets of a leveraged buyout financing. A high-yield issuer exhibits some or all of the following characteristics:

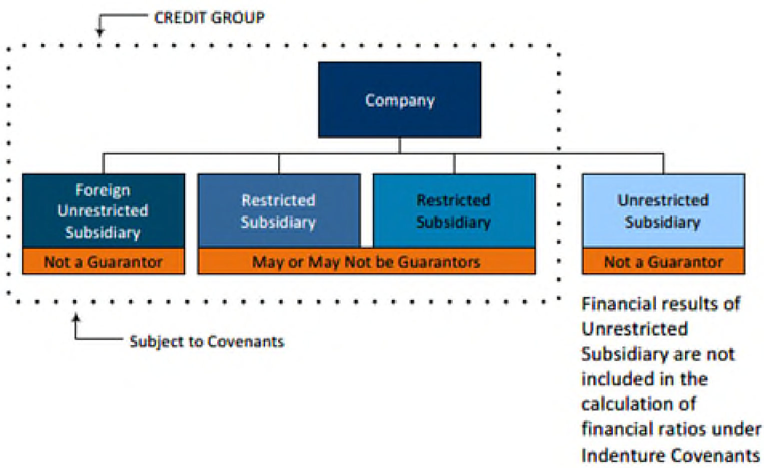
- stable and resilient business model;
- strong financial track record;
- growth or recovery story;
- market-leading positions in its industry or geography;
- favorable industry trends;
- experienced management team with proven track record;
- solid cash generation and future deleveraging potential; and
- financing needs of at least $100 million.

The Credit Group and Building the Credit Story

Understanding high-yield debt requires knowing which entities within a corporate group need to comply with the covenants. This basic concept will impact the covenant analysis and application that is discussed later in this Guide. For complex corporate structures, this structuring aspect can get fairly complicated, but the simple principle remains: the covenants should apply to entities generating positive cash flow and holding key operating assets that bondholders will look to for repayment.

The Issuer, any Guarantors and all Restricted Subsidiaries constitute the "**Credit Group**" and fall within what is sometimes referred to as "**the box**." Only the entities comprising the Credit Group (in other words, only those entities sitting within the box) are subject to the covenant package. The covenants aim to protect the bondholders 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 rating agencies, and ultimately impact the marketability and pricing of the bonds. Set forth below is an illustration of a typical Credit Group with the dotted line indicating "the box":



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, the financial reporting structure of the company and the location, terms and restrictions of any existing senior debt within the Credit Group. The high-yield product is very often structured as holding company ("**HoldCo**") financing with free movement of cash flows from subsidiaries to the HoldCo and vice-versa.

Although technically the issuance vehicle could be either the ultimate parent holding company, an intermediate holding company or a lower level operating company, the parent holding company will typically serve as the Issuer. For companies with international operations and subsidiaries organized in multiple jurisdictions, this decision as to which entity will be the Issuer of the bonds (as well as, which entities, if any, will be Guarantors of the bonds) will raise important tax considerations and, for certain jurisdictions, these tax considerations will be so considerable as to drive issuance structures.

Subsidiaries: Restricted and Unrestricted

The high-yield covenant package classifies all subsidiaries as either Restricted Subsidiaries or Unrestricted Subsidiaries. Restricted Subsidiaries are bound by the covenants contained in the indenture governing the bonds and Unrestricted Subsidiaries are not. Unless expressly designated as an Unrestricted Subsidiary, all subsidiaries of the Issuer are automatically classified as Restricted Subsidiaries under the indenture. For a subsidiary to become an Unrestricted Subsidiary, the subsidiary must be expressly designated as an Unrestricted Subsidiary either (i) in the indenture at the time the bonds are originally issued or (ii) at a later date by a resolution of the board of directors of the Issuer, provided the pre-conditions for such designation that are set forth in the indenture are satisfied at such time. For a discussion of the limitations and process of designating a Restricted Subsidiary as an Unrestricted Subsidiary (and re-designating an Unrestricted Subsidiary as a Restricted Subsidiary), See The High-Yield Bond Covenant Package — Limitation on Designation of Restricted and Unrestricted Subsidiaries.

There are positives and negatives to designating a subsidiary as an Unrestricted Subsidiary. On the positive side, Unrestricted Subsidiaries are not restricted at all by any of the indenture covenants to which the Issuer and its Restricted Subsidiaries are subject, and it may be very useful for a company to be able to grow and operate a portion of its business outside the confines of the indenture covenants. Thus, for example, an Unrestricted Subsidiary is able to incur unlimited amounts of debt (on a non-recourse basis to the Issuer or any Restricted Subsidiary), sell assets, create liens on its assets or make investments without restriction under, or application of, any of the indenture covenants. However, on the negative side, since Unrestricted Subsidiaries are not subject to the indenture covenants, their assets and cash-flows are susceptible to value-leakage transactions that the indenture covenants would have otherwise prohibited or limited. As a result, investors will not give much, if any, consideration to the assets and operating results of Unrestricted Subsidiaries when analyzing the credit quality of the Credit Group and determining whether to invest in the bonds. An Unrestricted Subsidiary's position outside the Credit Group and not being subject to the indenture covenants also results in various impacts under the high-yield covenant package, for example:

- the assets and financial results of Unrestricted Subsidiaries are not included in the calculation of financial measures (such as Total Assets) and financial ratios (such as the Fixed Charge Coverage Ratio (*i.e.*, the ratio of Consolidated EBITDA to Consolidated Fixed Charges)) under the indenture covenants and, therefore, do not affect (positively or negatively) covenant compliance for the Credit Group; and
- to prevent value being transferred outside the Credit Group, 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.

A classic example of a subsidiary that an Issuer might want to exclude from the high-yield covenant package would be a new project company, which has not yet become cash flow positive. This subsidiary would not be directly relevant to investors on the issuance date because its cash flow isn't supporting the credit story and its assets would likely be pledged to third-party project lenders. Later, when the project has been completed and is operational, the Issuer might consider re-designating the project company as a Restricted Subsidiary (assuming the pre-conditions to such designation could be satisfied) so as to gain the benefit of its positive cash flow on various covenants in exchange for subjecting it to the limitations imposed by the covenant package.

The Guarantors

High-yield bonds are frequently guaranteed by most, if not all, of the Issuer's Restricted Subsidiaries ("**upstream guarantees**"), and in secured offerings, such Guarantors also typically provide asset security for the bonds. The upstream guarantees give bondholders 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.

PRACTICE TIP

For investors in typical domestic high-yield structures, bondholders only receive subsidiary guarantees (and related share pledges) from domestic subsidiaries and do not receive guarantees from any foreign subsidiaries. In a default scenario, such structural subordination significantly limits bondholder access to foreign assets and places them and other domestic creditors at a significant disadvantage to foreign lenders with respect to those foreign assets.

Often, however, a Restricted Subsidiary is required to guarantee the bonds only if it guarantees other debt of the Issuer or another Guarantor. In some jurisdictions, guarantees by foreign subsidiaries can have negative tax consequences and it is therefore necessary to consult tax specialists early in the structuring process. For example, foreign subsidiaries of U.S. issuers usually do not act as Guarantors because, under prevailing 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.

As a general matter, the Issuer and the underwriters should consult local law experts as to any requirements for, and the enforceability and validity of, subsidiary and parent guarantees under applicable fraudulent conveyance, insolvency or similar laws.

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

Structuring the “right” high-yield covenant package requires balancing adequate protections for the bondholders with preserving the necessary operating flexibility to allow the Issuer to continue to implement its business plan. In other words, there is little point negotiating a highly “Issuer friendly” package that may be perceived by potential investors as “off market” and, therefore, may not be acceptable without a higher coupon. Likewise, Issuers need to carefully evaluate the various ways in which the covenant package would impact their existing and planned business to ensure that their activities are not unduly restricted and that future flexibility is present.

Achieving this tailored result, however, requires hard work and focus on the part of the Issuer and all parties when structuring the transaction. It is, therefore, critical for all parties involved in the drafting process to analyze and be fully familiar with the Issuer’s existing corporate organization and capital structure as well as to consider the Issuer’s business plans over the life of the bonds.

The Issuer should consider all reasonably foreseeable transactions and activities that the Issuer and its Restricted Subsidiaries 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 and requirements (e.g., equipment financing, sale and leaseback transactions, receivables 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, particularly if required to conduct its business at the time the bonds are issued; (vi) expected intra-group funds flows; and (vii) existing and potential related party transactions. Through this exercise, the Issuer will gain a greater understanding of the functioning of the covenants themselves while also identifying ways in which its business differs from other similar companies in an industry or country.

As a practical matter, legal 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 the Issuer’s legal 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 over the life of the bonds.

“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. High-yield incurrence covenants will be triggered only upon the taking of certain actions, such as incurring additional indebtedness, granting liens on assets or making so-called Restricted Payments (as defined below). This key difference in approach provides an advantage to Issuers in a declining market (e.g., when declining EBITDA causes leverage to increase) that might be caused by macroeconomic factors and not the direct consequence of management's business decisions.

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 dollar baskets, including a basket for indebtedness issued under the Issuer's senior credit facility and a basket for purchase money indebtedness used to acquire, construct or improve property, plant and equipment.

Certain baskets may grow and may also become depleted over time (e.g., baskets that are based on accumulated consolidated net income of the Issuer, reduced by the aggregate 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, non-dollar-restricted basket or pursuant to a basket designed for a specific category of transactions, rather than pursuant to a general, all-purpose, dollar-restricted 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, bondholders, which can be costly and time-consuming.

A common feature included in most of today's covenant packages is the suspension covenants provision, which provides that if the high-yield bond receives an investment-grade rating from two out of three rating agencies (or, if the bonds are rated only by two rating agencies, from two out of two rating agencies), most of the covenants in the high-yield covenant package will be automatically deemed suspended and only the "investment-grade covenants" will remain in effect. However, if the bonds subsequently fail to have an investment-grade rating from two out of three (or two out of two) rating agencies, then the suspended covenants will resume (meaning that such covenants "spring" back into existence).

The covenants that are typically suspended include:

- Limitation on Indebtedness;
- Limitation on Restricted Payments;
- Limitations on Restrictions on Dividends and Other Payments From Restricted Subsidiaries;
- Limitation on Asset Sales;

- Limitation on Transactions with Affiliates;
- Limitation on Guarantees of Indebtedness; and
- The financial ratio precondition to the Limitation on Merger, Consolidation and Sale of Substantially All Assets.

The "investment-grade covenants" that remain in effect typically include:

- Limitation on Liens;
- Limitation on Merger, Consolidation and Sale of Substantially All Assets;
- Change of Control; and
- Reporting.

No Default or Event of Default with respect to the suspended covenants will be deemed to have occurred on the date the suspended covenants are reinstated as a result of any actions taken by the Issuer or its Restricted Subsidiaries during the suspension period. Nonetheless, the Issuer and its counsel should pay careful attention as to how any actions taken during the suspension period are characterized under the suspended covenants when and if such covenants become effective again. For example, the following is a typical formulation as to how any indebtedness that is incurred during the suspension period is treated if the Limitation on Indebtedness covenant is reinstated:

On each Reversion Date, any Indebtedness Incurred during the Suspension Period will be classified as having been incurred, to the extent permitted, pursuant to the first paragraph of the Limitation on Indebtedness covenant or one of the clauses of the definition of Permitted Indebtedness. To the extent any such Indebtedness would not be so permitted to be incurred, such Indebtedness will be deemed to have been outstanding on the Issue Date, so that it is classified as permitted under clause (2) of the definition of Permitted Indebtedness.

A more permissive formulation of this provision, often found in Issuer-friendly, sponsor-driven covenant packages, would read as follows:

> *On each Reversion Date, all Indebtedness incurred during the Suspension Period will be deemed to have been outstanding on the Issue Date so that it is classified as permitted under clause (2) [Indebtedness in existence on the Issue Date] of the definition of Permitted Indebtedness.*

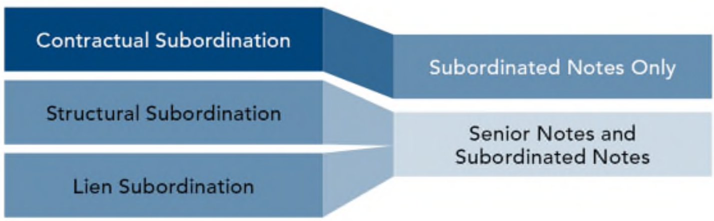
Obviously, the second formulation is more preferable from the Issuer's perspective since any Indebtedness incurred during the suspension period would not eat up precious dollar baskets, but an Issuer's ability to obtain such favorable formulation depends on negotiating strength and investors' perception of the Issuer's credit quality and prospects. In addition to the Limitation on Indebtedness covenant, the analysis of how any actions taken during the suspension period should be addressed with respect to each other suspended covenant.

Although infrequent, some very Issuer-friendly covenant packages have a fall-away covenant provision rather than a suspension covenant provision. The fall-away covenant provision provides that if the high-yield bonds receive an investment-grade rating from two out of three rating agencies (or from two out of two rating agencies), then the above-described suspended covenants are eliminated (*i.e.*, they fall away forever) and only investment-grade covenants will remain. The fall-away covenant provision is generally found in the covenant packages of highly rated sponsor deals that are on the cusp of achieving investment-grade ratings.

Subordination

High-yield bonds 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 main types 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, subordinated noteholders will not be paid and any amounts received by the subordinated noteholders will be turned over and paid 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 the subordinated notes for a specified period of time (typically 180 days). Additionally, the indenture will include standstill provisions, whereby the subordinated noteholders are required to give the holders of senior debt notice and wait for a certain period of time (typically 3 – 5 business days) before accelerating the subordinated notes.

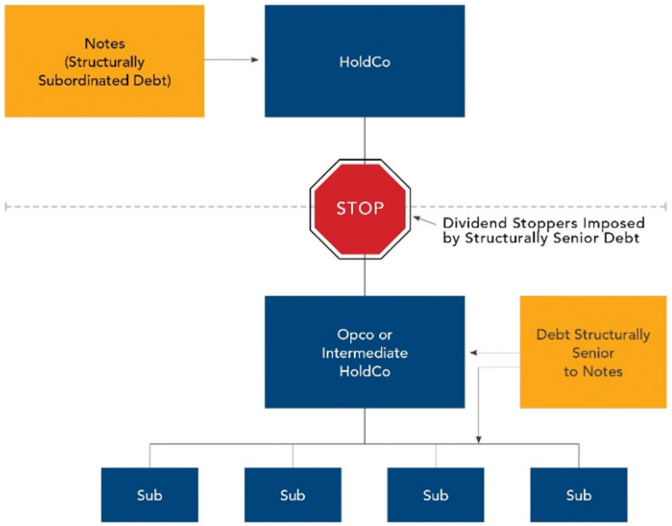
It should be noted that certain covenants in a subordinated note indenture will be different in some respects than those of a senior note indenture. For example, most unsecured subordinated note indentures permit all senior debt of the Issuer and its Restricted Subsidiaries to be secured, while unsecured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

PRACTICE TIP

When reviewing other deals to determine what is "market precedent," it is important not to 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 a good practice to obtain precedents of other companies that are in the same industry of the Issuer.

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. In this situation, 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 of the Issuer holding company are effectively junior in right of payment to the structurally senior debt of the operating company and its subsidiaries because upstream guarantees have not been provided by the operating company or its subsidiaries. As such, the operating company and its subsidiaries are not directly or indirectly 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 cash and other assets of the operating company and its subsidiaries. The only claim the creditors of the Issuer holding company 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.*, the claim of an equity holder). 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 companies, senior bank debt will often be secured by a first-priority lien on all or substantially all of the company'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 *pari passu* with the first-lien senior bank debt in the proceeds from collateral, 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 lien securing the high-yield bonds is generally a "silent" lien, meaning the administrative agent under senior bank debt will be the one making the decisions with respect to enforcement remedies on the collateral, meaning the agent will determine which assets to foreclose upon, when to foreclose and the manner of foreclosure, and the bondholders will be along for the ride. 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.

Redemption

Redemption is the contractual right of the Issuer to prepay, or "call," the bonds prior to their scheduled maturity. High-yield bonds typically have three principal redemption mechanics: (i) a redemption at a fixed redemption price following a non-call period, (ii) a redemption with a "make-whole" premium and (iii) the equity "claw-back" redemption. As a general matter, redemption is either not available or very expensive for the Issuer during the early life of a new bond to provide investors with protection that their funds will not be returned shortly after the initial investment decision. Such early repayment would be financially burdensome for investors, especially after spending the time and money to undertake the credit analysis to evaluate the initial purchase. As such, the pricing terms make a redemption more costly for the Issuer during the early years and less expensive during the later years in the life of the bonds.

Redemption at a Fixed Price

The optional redemption period starts after an initial customary non-call period (*e.g.*, five years for 10-year bonds and three years for eight-year bonds). The optional redemption pricing is the principal amount of the bond *plus* accrued interest and a fixed premium. The optional redemption premium starts out at half the interest rate (or coupon) of the bonds for the first year of the optional redemption period and declines ratably each year thereafter to par in the two to three years prior to maturity. The following are examples of typical redemption pricing for high-yield bonds – the first, an eight-year bond, and the second, a 10-year bond, both issued in 2020 with a 6.5% coupon:

6.50% Senior Notes due 2028 (issued 2020; 8NC3)

YEAR	PERCENTAGE
2023	103.250%
2024	101.625%
2025 and thereafter	100.000%

6.50% Senior Notes due 2030 (issued 2020; 10NC5)

YEAR	PERCENTAGE
2025	103.250%
2026	102.166%
2027	101.084%
2028 and thereafter	100.000%

Redemption with a Make-Whole Premium

Even during the so-called "non-call period," the Issuer often has the right to redeem all or a portion of the bonds, but the redemption premium during the non-call period, often referred to as a "make-whole" premium, can be very expensive. The make-whole premium is designed to make the bondholders whole by paying them an amount of money that is equal to the present value (determined at a discount rate of the then-current rate of the U.S. treasury security with a maturity equivalent to the earliest date the bonds are callable pursuant to the fixed optional redemption described above, *plus* a spread of generally

50 basis points) of all remaining payments on the bonds through and including the earliest date the bonds are callable pursuant to the fixed optional redemption, including all scheduled interest payments, principal and redemption premium. While expensive, the make-whole redemption nonetheless provides the Issuer with the ability to take out the bonds, at its option, at a pre-determined price.

Equity "Claw-back" Redemption

Within the first three years after the issuance date, the "equity claw-back" feature enables the Issuer to redeem up to 35% to 40% of the bonds using the proceeds of certain equity offerings by the Issuer within a certain period of time following the equity offering. The redemption price for the equity "claw-back" is typically set at par *plus* accrued interest, *plus* a redemption premium equal to the coupon on the bonds. The equity "claw-back" feature will contain a requirement that not less than 65% to 60% of the bonds initially issued under the indenture remain outstanding following the exercise of the equity "claw-back," so any earlier repurchases or redemptions of the bonds by the Issuer will act to reduce the available redemption amount under the equity "claw-back."

Historically, the equity "claw-back" generally only permitted proceeds from public offerings of equity securities to be used for the equity "clawback," particularly where the Issuers were private companies in order to encourage them to undertake an IPO and have access to the equity capital markets. However, over time, such requirements have been relaxed to include proceeds from private placements of equity securities and, with sponsored-backed Issuers, to even count contributions to the equity capital of the Issuer.

Another redemption feature that has become more common in recent years is what is sometimes referred to as a "**clean-up redemption**." This redemption provision provides that if the Issuer has undertaken a tender offer for all of the outstanding bonds, and holders of not less than 90% in aggregate principal amount of the outstanding bonds validly tender their bonds in such tender offer and the Issuer purchases all of the bonds validly tendered, then the Issuer will have the right, within 30 days following such purchase pursuant to such tender offer, to redeem all bonds that remain outstanding following such purchase at a price equal to the price offered to each other holder in such tender offer (*provided* such price shall not be less than 100% of the principal amount of bonds to be repurchased), *plus* accrued and unpaid interest.

The High-Yield Bond Covenant Package

This section provides a high-level overview 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 bonds, which is typical of most high-yield bond offerings. The covenants for secured or subordinated bonds 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 the covenant package is tailored for its specific operational needs.

Limitation on Indebtedness

The purpose of the Limitation on Indebtedness covenant is to:

- limit the amount of additional indebtedness that may be incurred by the Issuer and its Restricted Subsidiaries unless cash flow is sufficient to service all indebtedness; and
- control structural subordination by specifying where additional indebtedness can be incurred. See Subordination — Structural Subordination.

An example of the covenant is provided below.

On Section 4.05. Limitation on Indebtedness and Preferred Stock

(a) The Company will not, and will not permit any Restricted Subsidiary to, Incur any Indebtedness (including Acquired Indebtedness), and the Company will not permit any Restricted Subsidiary to issue Preferred Stock, provided that the Company or any Subsidiary Guarantor may Incur Indebtedness (including Acquired Indebtedness) and any Restricted Subsidiary may issue Preferred Stock if, after giving effect to the Incurrence of such Indebtedness and the receipt and application of the proceeds there from, (x) no Default has occurred and is continuing and (y) the Fixed Charge Coverage Ratio would be not less than 2.0 to 1.0.

*(b) Notwithstanding the foregoing, the Company and, to the extent provided below, any Restricted Subsidiary may Incur each and all of the following ("**Permitted Indebtedness**"):*

[Customary and negotiated list follows here.]

The covenant includes a general prohibition on the incurrence of indebtedness by the Issuer and its Restricted Subsidiaries, unless a ratio test can be satisfied on a *pro forma* basis after giving effect to the incurrence of such indebtedness (often referred to as "**Ratio Debt**") and exceptions to such general prohibition for certain types and/or amounts of indebtedness that can be incurred even if the ratio test cannot be satisfied (such exceptions defined as "**Permitted Indebtedness**").

The term "Indebtedness" is broadly defined to include guarantees, letters of credit, capital lease obligations, hedging obligations, "**Disqualified Stock**" of the Issuer (*i.e.*, stock that is required to be redeemed or could be redeemed at the option of the holder prior to the final maturity date of the high-yield bonds), any preferred stock of Restricted Subsidiaries and the deferred purchase price for any assets that remain unpaid for a specified period of time. Issuers may want to negotiate items that are expressly excluded as Indebtedness or be sure to include such items in the list of exceptions under Permitted 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 acquisitions (such as earn-outs). Industry-specific and unique operational requirements for specific businesses will be included here so as to ensure that the Issuer's existing business can continue to operate even if the incurrence of Ratio Debt is not available. As an example, 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 Exemption for "Ratio Debt"

The most common ratio test that is used in conjunction with the Limitation on Indebtedness covenant is the "**Fixed Charge Coverage Ratio**" (**FCCR**) (*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 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). Underwriters will typically prefer that only the Issuer and Subsidiary Guarantors are permitted to incur Ratio Debt, thereby limiting structural subordination. Typically, Issuers are not eligible to incur Ratio Debt when the bonds are issued, and therefore must initially depend upon the Permitted Indebtedness exceptions to incur additional debt.

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 commonly ranges between 2.0 and 2.5 to 1.0. For certain highly capitalized businesses, such as telecommunications, Ratio Debt will be calculated with a leverage ratio of all outstanding debt to EBITDA, which is considered a better measure of gearing given the nature of the capital structure of such businesses.

The definition of EBITDA is complex and often uniquely tailored to the Issuer's industry accounting approach, but is generally defined as net income of the Credit Group on a consolidated basis and calculated in accordance with generally accepted accounting principles ("GAAP"), with income taxes, depreciation and amortization expense added back to it.[1] From a high-level view, however, EBITDA is intended to measure the "run rate" of the business eliminating certain one-time events. In other words, EBITDA strives to represent normalized cash flow for the Issuer, but the details for the EBITDA definition must be carefully considered for each Issuer, as well as compared to other Issuers in similar industries and operating environments.

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 (discussed below). 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.

Fixed charges primarily include: (i) interest expense (cash and non-cash); (ii) amortization of debt issuance costs and original issue discount; (iii) the interest component of capital or finance leases; (iv) dividends on preferred stock; and (v) net payments under hedging

[1] Alternatively, EBITDA can also be defined as Adjusted Net Income *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 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 such net income is restricted from being distributed to the Issuer or a Restricted Subsidiary; and (v) the cumulative effect of a change in accounting principles.

obligations. It may also include, for certain types of businesses, other charges or expenses (*e.g.*, for retail and real estate 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, the incurrence and retirement of other debt (other than debt under revolving credit facilities) from the beginning of such four-quarter period to the calculation date (often referred to as the "**reference period**"), as well as acquisitions and dispositions during the reference period. For sponsor and other Issuer-friendly covenant packages, these pro forma adjustments will not only include add-backs for restructuring charges, facility closures and relocations and integration expenses that arise from mergers and acquisitions during the reference period, but also projected cost savings, operating improvements and other synergies that are expected to be achieved over the next 12- to 18-month period following the acquisition as reasonably determined by the Issuer's management, often (but not always) capped at 15% to 20% of EBITDA.

PRACTICE TIP

In calculating the Fixed Charge Coverage Ratio, *pro forma* effect must be given to debt incurred and repaid during the reference period. An often-overlooked exclusion to this general calculation is how to treat revolving credit borrowings and repayments that occur during the calculation period. To avoid this uncertainty, such borrowings and repayments should be excluded for purpose of such *pro forma* application (other than the amount of debt outstanding under revolving credit facilities on the calculation date).

The following is a basic illustration of how Consolidated EBITDA would be calculated with such pro forma adjustments related to an acquisition:

- Calculation date: 8/10/22
- Date of acquisition of Target: 2/1/22
- Projected costs savings from 2/1/22 to 7/31/23 (18 months post-acquisition): $35 million
- Indenture caps projected costs savings add-backs at 15% of Consolidated EBITDA

($ MM)		
Issuer EBITDA (LTM ended 6/30/22)	$110	* Only $30 million of the $35 million projected cost savings can be added back into the calculation of Consolidated EBITDA because the indenture caps such add-backs to 15% of Consolidated EBITDA before such add-backs (*i.e.*, $200 million ($110MM + $85MM + $5MM))
Target EBITDA (7/1/21 to 1/31/22)	$85	
Integration expenses	$5	
Project cost savings*	$30	
Consolidated EBITDA	$230	

Because the covenant is an "incurrence" covenant, it only tests the ratio at the time the Issuer or a Restricted Subsidiary seeks to incur additional indebtedness as Ratio Debt. An Issuer is permitted to maintain Ratio Debt and an Event of Default will not occur under the indenture even if the Issuer and its Restricted Subsidiaries subsequently fail to meet the Fixed Charge Coverage Ratio.

Limitation on Indebtedness: Basic Illustrations

The Limitation on Indebtedness covenant provides for:

- Ratio Debt, as long as FCCR is at least 2.0x
- Permitted Indebtedness baskets: (a) $500MM Credit Facility; (b) $200MM Senior Notes

Scenario A

($ MM)		
Credit Facility	$500	The Indebtedness covenant prevents the incurrence of additional debt under the ratio test and Permitted Indebtedness baskets
Senior Notes	$200	
Total debt	$700	Current FCCR (1.5x) is already less than FCCR (2.0x), and the Credit Facility basket and the Senior Notes basket have already been fully utilized
Issuer's FCCR	1.5x	
Additional debt permitted	$0	

It is important to note that the Issuer would not be in violation of the covenant unless it incurred additional indebtedness

If the Issuer had sufficient liquidity and did not incur additional debt, it would avoid violating this covenant

Scenario B

($ MM)		
Credit Facility	$400	Although the calculation of the Issuer's FCCR is below 2.0x, it has additional borrowing capacity given that it has only used up $400MM of its $500MM Credit Facility basket
Senior Notes	$200	
Total debt	$600	
Issuer's FCCR	1.5x	
Additional debt permitted	$100	

The Permitted Indebtedness Exemption

The covenant will also permit numerous categories of "**Permitted Indebtedness**" 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 the Permitted Indebtedness exemption will be negotiated between the Issuer and the underwriters, and are contained in the text of the Limitation on Indebtedness covenant.

PRACTICE TIP

Practitioners often question whether an initial debt incurrence may be divided between Ratio Debt and Permitted Indebtedness, and if so, whether the portion allocated to Permitted Indebtedness 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 Indebtedness, as well as the discharge of any Permitted Indebtedness with the proceeds of such allocated amount, shall be ignored for purposes of calculating the amount of Ratio Debt which may be incurred.

Permitted Indebtedness typically includes:

- The "**Credit Facility basket**" – this basket is designed to cover the Issuer's existing primary credit facility and any refinancing thereof, and can include any other indebtedness meeting the definition of "Credit Facility," which is generally defined broadly enough to include almost all types of debt facilities, even indentures and debt securities issued thereunder. The amount of indebtedness that can be incurred under the Credit Facility basket is typically restricted to a fixed dollar amount that is sufficient to cover the maximum amount that can be borrowed under the Issuer's existing primary credit facility, including any potential increase in the size of the facility pursuant to any "accordion" feature thereunder.[2] In addition, this basket often includes a "**growth component**" so that the cap is the greater of (x) the fixed dollar amount and (y) a specified financial metric, such as a multiple of *Pro forma* EBITDA for the prior four fiscal quarters, a percentage of Total Assets or an amount of additional indebtedness that does not cause the Senior Secured Leverage Ratio to exceed a specified level.

- "**Ordinary Course Indebtedness**" – indebtedness represented by such things as letters of credit supporting workers' compensation claims, health benefits, disability and other employee benefits, self-insurance obligations and performance, surety, appeal or similar bonds. This basket is not capped at a dollar amount, but would not include indebtedness for borrowed money.
- "**Existing Indebtedness**" – indebtedness of the Issuer or any Restricted Subsidiary existing on the issue date of the bonds that is not otherwise included within any other Permitted Indebtedness exception. This exception typically excludes indebtedness outstanding on the issue date under the Issuer's primary credit facility, which is deemed incurred under the Credit Facility basket, indebtedness represented by the bonds and other identified Permitted Indebtedness exceptions so as to prevent the Issuer from "emptying-out" and refreshing such other baskets by characterizing such debt as "Indebtedness existing on the issue date."
- **Bonds or Notes offered** – indebtedness represented by the bonds or notes issued on the issue date and any related guarantees (together with any registered exchange notes and related guarantees). Because "notes" is typically defined to include all notes issued under the indenture, including, if the indenture permits, any

[2] The accordion is a provision included in many credit facilities pursuant to which the borrower has the ability to incur up to an agreed-upon, but uncommitted, amount of additional debt under the facility, which additional debt will be governed by the existing loan documentation and supported by the same guarantees and collateral package that supports the original debt under the credit facility.

additional notes issued thereafter (as a single fungible series with equal rights and identical terms as the notes issued on the original issue date), 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 Indebtedness** – indebtedness incurred to refinance Ratio Debt, Existing Indebtedness, the bonds or other identified categories of Permitted Indebtedness. Permitted Refinancing Indebtedness typically has the following requirements:
  - ➢ the principal amount of such Permitted Refinancing Indebtedness does not exceed the principal amount and accrued interest of the indebtedness being refinanced, *plus* the costs of such refinancing;
  - ➢ the Permitted Refinancing Indebtedness has a final maturity date no earlier than the earlier of the final maturity date of the indebtedness being refinanced or 91 days after the final maturity date of the bonds;
  - ➢ the Permitted Refinancing Indebtedness has a weighted average life that is equal to or greater than the shorter of (a) the weighted average life of the indebtedness being refinanced and (b) 91 days after the final maturity date of the bonds;
  - ➢ if the indebtedness being refinanced is contractually subordinated to the bonds or a Subsidiary Guarantee, such Permitted Refinancing Indebtedness is similarly contractually subordinated to the bonds or such Subsidiary Guarantee; and
  - ➢ the Permitted Refinancing Indebtedness shall not include indebtedness of a Restricted Subsidiary that is not a Subsidiary Guarantor that refinances indebtedness of the Issuer or a Subsidiary Guarantor (thereby limiting structural subordination).

PRACTICE TIP

A common mistake in drafting dollar-restricted Permitted Indebtedness baskets is allowing the Permitted Refinancing Indebtedness basket to "empty out" and "refresh" such dollar-restricted Permitted Indebtedness baskets. This allows the Issuer to become more highly leveraged than the bondholders intended. To avoid this result, each dollar-restricted Permitted Indebtedness basket should include in its calculation of the maximum amount of indebtedness that can be incurred and be outstanding at any time under such basket any indebtedness that has refinanced such indebtedness.

- **Purchase Money Indebtedness** – indebtedness, including capitalized lease obligations, mortgage financings and purchase money obligations, incurred to finance the acquisition, construction, installation or improvement of property, plant and equipment. Most often, this basket is capped at a fixed dollar amount and often a "growth component," such as a percentage of Total Assets, but in Issuer-friendly, sponsor-driven covenant packages, it may not be subject to a cap at all other than not exceeding the cost of the acquisition, construction, installation or improvement.
- **Intercompany Indebtedness** – intercompany borrowings between and among the members of the Credit Group, *provided* that any indebtedness owned by the Issuer or a Subsidiary Guarantor to a Restricted Subsidiary that is not a Subsidiary Guarantor is required to be expressly subordinated to the bonds or the Subsidiary Guarantee as the case may be.

- **Hedging Obligations** – indebtedness represented by hedging obligations designed to protect against fluctuations in interest rates, currency exchange rates or commodity prices, *provided* such obligations are not incurred for speculative purposes.
- **Acquired Indebtedness basket** – indebtedness of an acquired company or business that is existing at the time of the acquisition, *provided* that either on a *pro forma* basis after giving effect to such acquisition and incurrence of such indebtedness, either (x) the ratio test applicable to Ratio Debt can be satisfied after giving pro forma effect to the acquisition and the incurrence of such indebtedness or (y) the ratio test on such pro forma basis is no worse than the Issuer's ratio test prior to giving effect to the acquisition and the incurrence of such indebtedness. This basket is typically restricted to indebtedness that is existing at the time, and not incurred in contemplation, of the acquisition. However, for sponsor deals, Issuers that are close to an investment grade rating or during attractive market conditions, this basket is often loosened to also allow for indebtedness that is incurred to finance the acquisition.
- **General Indebtedness basket** – indebtedness that may be incurred for any purpose and is typically capped at a fixed dollar amount, but sometimes includes a "growth component."
- **Other negotiated baskets** – Permitted Indebtedness will include other specific baskets to address the needs of the Issuer and its business plan (*e.g.*, indebtedness of foreign subsidiaries under local lines of credit).
- **Sponsor deal baskets** – Two Permitted Indebtedness baskets commonly found in sponsor deals, the first of which has begun creeping into some non-Sponsor deals, include:
  - **Contribution Indebtedness basket** – indebtedness in an amount equal to the aggregate amount (or, in very aggressive covenant packages, up to 200%) of contributions made to the equity capital of the Issuer or from the issuance of equity securities (other than Disqualified Stock) of the Issuer after the issue date of the bonds, *provided* such contributions or equity

proceeds are not also used to make a Restricted Payment or a Permitted Investment.

- **Available RP Builder basket** – indebtedness in an amount equal to the "Restricted Payments Builder basket" under the Limitation on Restricted Payments covenant (discussed below), *provided* that the amount of such indebtedness outstanding at any time shall be deemed a Restricted Payment for purposes of determining the capacity to make Restricted Payments under the Restricted Payments Builder basket.

With respect to Ratio Debt and each basket of Permitted Indebtedness, the Issuer and its counsel will focus on the amount of the ratio in the ratio test, the dollar amounts and the type and percentages of any "growth components" in the dollar-restricted Permitted Indebtedness baskets. But an often-overlooked element that the Issuer and its counsel need to focus on is which entities are permitted to incur Ratio Debt and the debt under each Permitted Indebtedness basket. Can the debt be incurred only by the Issuer and Subsidiary Guarantors, or can it also be incurred by Restricted Subsidiaries that are not Subsidiary Guarantors? The Issuer must be sure the Limitation on Indebtedness covenant provides sufficient flexibility for the Issuer and its Restricted Subsidiaries to raise debt capital as and where needed in accordance with the Issuer's growth strategy, while not demanding so much flexibility that investors become concerned about the possibility of the Issuer becoming over-leveraged.

PRACTICE TIP

With respect to dollar-restricted Permitted Indebtedness baskets (including ones with "growth components"), a nice feature Issuers should be sure to include is the concept that the portion of any Refinancing Indebtedness incurred to pay accrued and unpaid interest, premiums (including tender premiums), fees (including underwriting fees) and other expenses incurred in connection with such refinancing (sometimes defined as the “Additional Refinancing Amount”) be added to (and thereby not “eat up” capacity of) the dollar cap of such basket. The following is an example of the General Indebtedness basket with such feature:

> (k) Indebtedness of the Issuer or any Restricted Subsidiary in an aggregate principal amount, together with the aggregate principal amount of Indebtedness then outstanding and Incurred pursuant to this clause (k), together with any Refinancing Indebtedness in respect thereof, not to exceed the greater of $400 million and 1.5% of Total Assets (*plus*, in the case of any Refinancing Indebtedness, the Additional Refinancing Amount).

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 (or any portion thereof) 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 outstanding under the Credit Facility basket on the issue date of the bonds). 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 Indebtedness baskets as Ratio Debt. This action serves to free up capacity under the relevant Permitted Indebtedness baskets. Such a reclassification is also advantageous in the event of a refinancing of Permitted Indebtedness. For example, refinancing debt with Ratio Debt need not comply with the limitations required by the definition of Permitted Refinancing Indebtedness.

PRACTICE TIP

It will almost always be better 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 Indebtedness basket. This is because any indebtedness incurred in reliance on a basket will be factored in when calculating future proposed incurrences under the Fixed Charge Coverage Ratio anyway and also use up capacity under the specified Permitted Indebtedness basket.

Other Covenants to Consider

When 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, because 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 Limitation on 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 particularly to stakeholders that are junior in right of payment to the bondholders (also referred to as “**leakage**”) unless the Credit Group’s positive financial performance or improved financial condition justifies its ability to make such payments. This protection is important to bondholders 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. In short, this covenant limits leakage unless the transfer of cash and other assets has been earned.

The covenant is structured into three parts. The first part defines what constitutes a Restricted Payment. The second part of the covenant sets forth the conditions that must be satisfied in order for the Issuer or a Restricted Subsidiary to make a Restricted Payment and limits the amount of Restricted Payments that may be made to a calculation that is often referred to as the “Net Income Builder basket” or the “Restricted Payments Builder basket” because the amount is based on the Issuer’s Consolidated Net Income which accumulates (or “builds”) over time. The third part of the covenant sets forth a list of exceptions to the covenant (i.e., a list of Restricted Payments that can be made even if the conditions set forth in the second part of the covenant are not satisfied).

An example of the covenant is provided below:

Section 4.06. Limitation on Restricted Payments.

The Issuer will not, and will not permit any Restricted Subsidiary to, directly or indirectly (the payments or any other actions described in clauses (i) through (iv) below being collectively referred to as "Restricted Payments"):

(i) declare or pay any dividend or make any distribution on or with respect to the Issuer's or any of its Restricted Subsidiaries' Capital Stock (other than dividends or distributions payable or paid in shares of the Issuer's Capital Stock (other than Disqualified Stock) or in options, warrants or other rights to acquire such shares) held by Persons other than the Issuer or any Wholly Owned Restricted Subsidiary;

(ii) purchase, call for redemption or redeem, retire or otherwise acquire for value any shares of Capital Stock of the Issuer (including options, warrants or other rights to acquire such shares of Capital Stock) or any direct or indirect parent of the Issuer held by any Persons other than the Issuer or any Wholly Owned Restricted Subsidiary;

(iii) make any voluntary or optional principal payment, or voluntary or optional redemption, repurchase, defeasance or other acquisition or retirement for value, prior to any scheduled maturity of Indebtedness that is subordinated in right of payment to the Notes or any of the Subsidiary Guarantee (other than Indebtedness owed by the Issuer or any Restricted Subsidiary to another Restricted Subsidiary or the Issuer, or any such payment on Indebtedness due within one year of the date of payment, redemption, repurchase, defeasance or other acquisition or retirement); or

(iv) make any Investment, other than a Permitted Investment;

if, at the time of, and after giving effect to, the proposed Restricted Payment:

(A) a Default has occurred and is continuing or would occur as a result of such Restricted Payment;

(B) the Company could not Incur at least $1.00 of Indebtedness under the proviso in 4.05(a);[3] *or*

(C) such Restricted Payment, together with the aggregate amount of all Restricted Payments made by the Issuer and its Restricted Subsidiaries after the Issue Date, shall exceed the sum of:[4]

1. 50% of the aggregate amount of the Consolidated Net Income of the Issuer (or, if the Consolidated Net Income is a loss, minus 100% of the amount of such loss) accrued on a cumulative basis during the period (taken as one accounting period) beginning on the first day of the fiscal quarter during which the Issue Date occurred and ending on the last day of the Company's most recently ended fiscal quarter for which consolidated financial statements of the Issuer are available; plus

2. 100% of the aggregate Net Cash Proceeds, and the Fair Market Value of any assets other than cash, received by the Issuer after the Issue Date as a capital contribution to its common equity or from the issuance and sale of its Capital Stock (other than Disqualified Stock) to a Person who is not a Subsidiary of the Issuer, including any such Net Cash Proceeds received upon (x) the conversion of any Indebtedness of the Issuer into Capital Stock (other than Disqualified Stock) of the Issuer, or (y) the exercise by a Person who is not a Subsidiary of the Issuer of any

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[3] Cross-reference relates to the Ratio Debt test under the Limitation on Indebtedness covenant.

[4] The Sum of subsections 1 through 5 is the "Net Income Builder basket" or "Restricted Payments Builder basket."

options, warrants or other rights to acquire Capital Stock of the Issuer (other than Disqualified Stock) in each case excluding the amount of any such Net Cash Proceeds used to redeem, repurchase, defease or otherwise acquire or retire for value any Subordinated Indebtedness or Capital Stock of the Issuer; plus

3. the amount by which Indebtedness of the Issuer or any of its Restricted Subsidiaries is reduced on the Issuer's consolidated balance sheet upon the conversion or exchange (other than by a Subsidiary of the Issuer) subsequent to the Issue Date of any Indebtedness of the Issuer or any of its Restricted Subsidiaries (less the amount of any cash, or the Fair Market Value of any other property, distributed by the Issuer upon such conversion or exchange); plus

4. an amount equal to the net reduction in Investments (other than reductions in Permitted Investments) that were made after the Issue Date in any Person resulting from (v) payments of interest on Indebtedness, dividends or repayments of loans or advances by such Person, in each case to the Issuer or any Restricted Subsidiary (except, in each case, to the extent any such payment or proceeds are included in the calculation of Consolidated Net Income) after the Issue Date, (w) the unconditional release of a Guarantee provided by the Issuer or a Restricted Subsidiary after the Issue Date of an obligation of another Person, (x) to the extent that an Investment made after the Issue Date was, after such date, or is sold or otherwise liquidated or repaid for cash, the lesser of (i) cash return of capital with respect to such Investment (less the cost of disposition, if any) and (ii) the initial amount of such Investment, (y) from redesignations of Unrestricted Subsidiaries as Restricted Subsidiaries, not to exceed, in each case, the amount of Investments (other than Permitted Investments) made by the Issuer or a Restricted Subsidiary after the Issue Date in any such Person or (z) any Person becoming a Restricted Subsidiary *(whereupon all Investments made by the Issuer or any Restricted Subsidiary in such Person since the Issue Date shall be deemed to have been made pursuant to clause (1) of the definition of "Permitted Investment") but only to the extent such Investments by the Issuer or any Restricted Subsidiary in such Person was a Restricted Payment made to the extent permitted under this paragraph (C); plus*

5. *$20.0 million.*

(b) The foregoing provision shall not be violated by reason of:

[Customary list of exclusions follow here.]

Definition of Restricted Payments

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

- paying cash dividends or making other distributions of assets to stockholders of the Issuer; *provided, however*, that dividends paid in capital stock of the Issuer (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).

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 and, as a result, the Credit Group no longer has control over the invested assets. 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 within the Credit Group.

Conditions to Making a Restricted Payment Using the Net Income Builder Basket

Unless it falls within the list of permitted Restricted Payments set forth in the third part of the covenant, a Restricted Payment cannot be made unless the following conditions are satisfied:

(1) the Issuer must be able to incur $1.00 of Ratio Debt under the Limitation on Indebtedness covenant (after giving *pro forma* effect to the Restricted Payment);

(2) no default can or would exist under the indenture after giving effect to the Restricted Payment; and

(3) the amount of the proposed Restricted Payment *plus* all prior Restricted Payments since the issue date of the bonds

(subject to certain exceptions discussed below) cannot exceed the amount of the Net Income Builder basket.

Recently, some sponsor-driven covenant packages have softened these requirements such that conditions (1) and (2) above do not apply to Restricted Payments that are investments and, in very aggressive packages, are eliminated entirely and therefore are not applicable to any Restricted Payments.

Calculation of the Net Income Builder Basket

The Net Income Builder basket is calculated as follows:

- 50% cumulative Consolidated Net Income of the Issuer and its Restricted Subsidiaries (or if such amount is a loss, 100% of such loss), for the period from the beginning of the quarter during which the bonds are issued[5] 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) received by the Issuer since the issue date of the bonds from (i) capital contributions to the Issuer, (ii) issuances of equity by the Issuer (other than (x) issuances of Disqualified Stock and (y) issuances to a subsidiary) and (iii) issuances of any debt of the Issuer or any Restricted Subsidiary subsequently converted into or exchanged for (other than by a subsidiary of the Issuer) equity of the Issuer (other than Disqualified Stock); *plus*
- net reductions in investments that have been made since the issue date of the bonds pursuant to the Net Income Builder basket (*i.e.*, not Permitted Investments) to the extent not included in Consolidated Net Income such as:

[5] If the Issuer's Consolidated Net Income for this fiscal quarter is negative, then often the period will begin with the fiscal quarter immediately following the issue date of the bonds.

- 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 Builder basket;
- the net reduction in investments made pursuant to the Net Income Builder basket resulting from dividends, repayments of loans or advances or other transfers of assets to Issuer or any Restricted Subsidiary;
- to the extent the amount available for investments under the Net Income Builder 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;
- the net reduction in investments made pursuant to the Net Income Builder basket resulting from repayment of letters of credit, the expiration of a letter of credit undrawn or the release of any guarantees; *plus*
- $[XX] million [a negotiated dollar amount].

When analyzing the Limitation on Restricted Payments covenant, timing must be carefully considered. The Net Income Builder basket will be zero on the date of issuance unless "seeded" with a starter amount (as provided in the immediately preceding bullet above). The Net Income Builder basket will build over time, if the Issuer's financial performance is positive. However, the Issuer will want to consider whether it will need to make any Restricted Payments during the initial six to 12 months. If, for example, management wants to pay dividends during such period because the Issuer has a history of making such payments as a public company, the working group must consider ways to enable the Issuer to make such payments, which will be expected by equity investors despite there being "leakage" from a bondholder perspective.

PRACTICE TIP

The add-back for returns on investments should be limited to investments which originally were subtracted from the Net Income Builder Basket. If, instead, those investments were made utilizing a specific Permitted Restricted Payment basket or Permitted Investment basket, then it makes sense for the investment return to be netted against those baskets, not the Net Income Builder Basket. Nonetheless, some Issuer-friendly, sponsor-driven covenant packages net investment returns from any investment constituting a Permitted Restricted Payment or Permitted Investment as well as including such amount in the calculation of the Net Income Builder Basket, thereby double-counting such amounts and increasing Restricted Payments capacity.

Similarly, 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 (or to incur indebtedness pursuant to the "Contribution Indebtedness basket" described above), any capital contribution or equity proceeds used for those specific exceptions is not also used to increase the amount of the Net Income Builder basket.

Net Income Builder Basket Calculation: An Example

($ MM)	Period 1	Period 2	Period 3
Net Income	$100	$100	$100

50% of Consolidated Net Income for the relevant periods = $300,000,000 x 50% = **$150,000,000**, which would be reduced by any Restricted Payments made since the issue date of the bonds pursuant to the Net Income Builder basket.

Restricted Payments: Basic Illustrations

Net Income Builder basket (50% of Consolidated Net Income): $150MMGeneral Restricted Payment (RP) basket: $100MM

Fix Charge Coverage Ratio (FCCR) under the Indebtedness covenant: 2.0x

Scenario A

($ MM)		The Issuer is able to utilize its entire $150MM Net Income Builder basket as its FCCR of 2.5x exceeds the 2.0x FCCR requirement, as well as the $100MM General RP basket, which has not yet been used
FCCR	2.5x	
General RP basket used	$0	
Net Income Builder basket	$150	
Permitted Restricted Payments	$250	

Scenario B

($ MM)		Although the Issuer has a Net Income Builder basket of $150MM, the Issuer is not able to incur $1.00 of additional indebtedness because the Issuer has a FCCR of 1.5x and must have an FCCR of at least 2.0x. However, the Issuer can still utilize the $100MM General RP basket, which has not been used
FCCR	1.5x	
General RP basket used	$0	
Net Income Builder basket	$150	
Permitted Restricted Payments	$100	

Scenario C

($ MM)		The Issuer is unable to make a Restricted Payment because (i) it cannot use the $150MM Net Income Builder baskets since its FCCR ratio is only 1.5X and (ii) the $100MM General RP basket has already been used
FCCR	1.5x	
General RP basket used	$100	
Net Income Builder basket	$150	
Permitted Restricted Payments	$0	

Permitted Restricted Payments

Certain Restricted Payments can be made without regard to the Net Income Builder basket or the conditions to using the Net Income Builder basket, often referred to as "**Permitted Restricted Payments**," and they typically include:

- **"Credit neutral transactions"** – or Restricted Payments made in connection with transactions that are, on a net-basis, credit neutral from a bondholder's perspective (*i.e.*, the bondholders are no worse off). Such types of Restricted Payment baskets include:
  - ➢ the acquisition of capital stock or other equity interests of the Issuer out of the proceeds of, or in exchange for, a concurrent issuance of capital stock or other equity interests of the Issuer (other than Disqualified Stock);
  - ➢ repurchases of subordinated debt out of proceeds of concurrent issuance of capital stock or other equity interests of the Issuer or concurrent incurrence of subordinated Permitted Refinancing Indebtedness; *provided* that the proceeds from any issuance of capital stock or other equity interests of the Issuer are not factored into the calculation of the Net Income Builder basket described above (*i.e.*, no double-counting of such proceeds).

- **Repurchases of equity from management and personnel** – this basket permits the Issuer to repurchase equity from officers, directors, employees and sometimes consultants of the Issuer and any Restricted Subsidiary pursuant to any employee benefit plan or agreement, subject to an annual dollar cap, with unused amounts often able to be rolled over to the following year(s), with roll-over amounts sometimes subject to an additional cap. This basket gives the Issuer the flexibility to structure equity compensation plans to incentivize, retain and attract company personnel, and is particularly important for private companies since there is no market for the Issuer's equity securities to provide liquidity for the equity incentives granted to the Issuer's personnel.
- ***De minimis* Restricted Payments** – these baskets are to cover Restricted Payments that are generally not material from a bondholder's perspective and relieve the Issuer from the administrative hassle of tracking them and figuring out which basket they would fall under and eat up dollar capacity. Such baskets include:
    - repurchases of capital stock of the Issuer deemed to occur upon the net- or "cashless-" exercise of stock options and warrants;
    - the payment of cash in lieu of issuing fractional shares of capital stock in connection with any stock dividend, stock split or combination thereof or upon the exercise of options, warrants and other securities; and
    - payments or distributions to certain stockholders to satisfy dissenters' rights pursuant to or in connection with any consolidation, merger or transfer of assets that complies with the indenture.
- **Dividends on Disqualified Stock** – while not present in every covenant package, this basket permits the payment of dividends on any Disqualified Stock of the Issuer or any preferred stock of any Restricted Subsidiary issued or incurred after the issue date of the

bonds in accordance with the Limitation on Indebtedness covenant, in each case to the extent that such dividends are included in the definition of "Consolidated Fixed Charges."

- The theory behind this basket is that if the obligations could be incurred under the Limitation on Indebtedness covenant as either debt or disqualified/preferred stock and Issuer "takes the same hit" for the issuance of the disqualified/preferred stock as it would if the obligations were incurred as debt in terms of principal amount (*i.e.*, liquidation preference) and the dividends counting the same as interest expense, then why not provide the flexibility under the Limitation on Restricted Payments covenant to pay dividends on such preferred stock. As between debt obligations and preferred stock for purposes of raising capital, bondholders would prefer the issuance of preferred stock over the incurrence of debt since the preferred stock would be junior in right of payment to the bonds in the event of a bankruptcy or liquidations proceeding.
- **Restricted Payments made with Excluded Contributions** – this basket allows the making of any Restricted Payment in an aggregate amount up to the amount of "**Excluded Contributions**," which are generally defined as the net cash proceeds, and the Fair Market Value of property other than cash, received by the Issuer after the issue date of the bonds from (i) contributions to its common equity capital and (ii) the sale of capital stock of the Issuer (other than Disqualified Stock), in each case designated as Excluded Contributions pursuant to an Officers' Certificate of the Issuer delivered to the Trustee, *provided* such Excluded Contributions are excluded from the calculation of the Net Income Builder basket described above. The Excluded Contribution basket is similar to a "credit-neutral transaction" described above; however, the Restricted Payments made under the Excluded Contributions basket do not have to be made at or near the time of the equity contribution or sale of capital stock, but can be made many years later.

- **Dividends to any parent company to cover income taxes and overhead costs** – this basket is necessary where the Issuer is a subsidiary of a parent company and is designed to allow the Issuer to make dividends or other distributions up to the parent company to cover (i) federal and state income taxes where the parent company files a consolidated tax return to the extent such taxes are attributable to the income of the Issuer and its subsidiaries and (ii) the fees and expenses of the parent company to cover general corporate overhead expenses of the parent company, including the compensation and benefits paid to directors, officers and employees of the parent company, legal, tax, accounting and other professional fees and expenses of the parent company, and amounts required to pay any listing fees and other costs and expenses attributable to being a publicly traded company. The idea behind this basket is that these dividends are designed to cover costs that would have been incurred by the Issuer directly if it were not the subsidiary of a parent holding company.
- **Pro-rata dividends by non-wholly owned Restricted Subsidiaries to third parties** – dividends and distributions made by Restricted Subsidiaries to the Issuer or another Restricted Subsidiary are not Restricted Payments, but dividends and distributions made outside the Credit Group to third parties are often defined as Restricted Payments. Companies are required either by law and/or their charter documents to pay dividends to all shareholders *pro rata* (*i.e.*, with respect to each class or series of capital stock, companies are prohibited from paying dividends to some stockholders and not others). Without this basket, every time a non-wholly owned Restricted Subsidiary wanted to pay a dividend, it would have to find capacity under the Net Income Builder basket or some other dollar-capped Permitted Restricted Payment basket in order to pay the portion of the dividends payable to the third-party minority interest. If sufficient capacity was not available, the dividend could not be made, including to the Issuer or another Restricted Subsidiary. Often, this exception is drafted to be an exclusion to the definition of Restricted Payments, thereby eliminating the need for a basket.

- **General Restricted Payments basket** – this basket allows any Restricted Payment to be made for any reason, *provided* that the aggregate amount of all Restricted Payments to be made under the General Restricted Payments basket does not exceed a cap of either a fixed dollar amount or the greater of a fixed dollar amount and a "growth component," such as a percentage of Total Assets or Consolidated EBITDA.
- **Leverage ratio basket** – this basket was initially found only in very aggressive covenant packages for sponsor deals; however, in recent years, it has been showing up more and more in non-sponsor covenant packages, but generally only for credits in the higher end of the high-yield spectrum. This basket allows for any Restricted Payment to be made as long as at the time of, and immediately after giving effect to, such Restricted Payment, the Issuer's Total Leverage Ratio (*i.e.*, the ratio of total debt of the Issuer and its Restricted Subsidiaries to Consolidated EBITDA) is less than a specified ratio.
- **Other negotiated baskets** – the Issuer and its counsel need to be sure that the list of Permitted Restricted Payments include other baskets that may be necessary to address the current and future needs of the Issuer's capital structure, business strategies and growth plans (*e.g.*, baskets for limited investments in joint ventures or investments in Unrestricted Subsidiaries (both of which could also be addressed under Permitted Investments discussed below)). There might also be a desire to redeem an outstanding series of preferred stock of the Issuer or take out minority stockholders in the Issuer.

Which Permitted Restricted Payments Count Against the Net Income Builder Basket?

In theory, all Permitted Restricted Payments count against the Net Income Builder basket, other than Restricted Payments that:

- expressly provide that the net cash proceeds or assets utilized in such Permitted Restricted Payment do not also build the Net Income Builder basket (*e.g.*, Restricted Payments made with the proceeds of, or in exchange for, an issuance of capital stock);

- are credit-neutral (*e.g.*, the refinancing of subordinated debt with new subordinated Permitted Refinancing Indebtedness); or
- are *de minimis* (paying cash in lieu of issuing fractional shares, etc.).

However, due to either its gradual erosion over time or maybe the lack of investor focus on it being strictly followed or both, the general rule stated above is frequently neglected and often some Permitted Restricted Payments, even ones that allow for non-*de minimis* amounts of leakage to occur, will not count against the Net Income Builder basket. In short, there is room for negotiation here, because the market precedent is all over the map.

Permitted Investments

Permitted Investments are, by definition, not Restricted Payments. When determining Permitted Investment baskets, practical consideration must be given to how the Issuer conducts its business and whether it has a history of making the type of investments being proposed. Although some covenant packages seem to adopt a "lowest common denominator" approach where all possible carve-outs are proposed, a better approach is to tailor the package to fit the Issuer's current and future needs precisely.

Permitted Investments generally include:

- investments in the Issuer and any Restricted Subsidiary (sometimes limited to investments in Restricted Subsidiaries that are Guarantors and not encompassing non-Guarantor Restricted Subsidiaries);
- investments in any entity that becomes a Restricted Subsidiary as a result of the investment, and any investments held by such entity on the date it becomes a Restricted Subsidiary as long as such investments were not made in contemplation thereof;
- investments in existence on the issue date of the bonds;
- certain enumerated hedging transactions;
- loans or advances to officers or directors, subject to a dollar cap;

- investments in joint ventures, subject to a dollar cap and often a "growth component";
    - It is very common for this basket to be limited to joint ventures that are in a "Similar Business" or "Permitted Business," and the Issuer and its counsel will want to be sure such definition is broad enough to capture any type of business the Issuer plans to enter in the future and any business that is reasonably related, incidental, complementary or ancillary thereto (*see also* "Lines of Business" below);
- investments in cash, cash equivalents and investment-grade securities; and
- other investments, subject to a dollar cap or the greater of a dollar cap and a "growth component."

If the Issuer is able to negotiate the inclusion of a Leverage Ratio Permitted Restricted Payments basket, then the definition of Permitted Investments should include a similar basket (*i.e.*, any investment made as long as at the time of, and after giving effect to, such investment, a specified leverage ratio test is satisfied). The leverage ratio for the Permitted Investment basket is generally set at a level that is 1.0x to 0.5x lower (*i.e.*, easier) than the ratio for the Leverage Ratio Permitted Restricted Payments basket since, in the spectrum of Restricted Payments, investors prefer investments over the other types of Restricted Payments.

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 Builder basket. Consequently, an Issuer will prefer an investment be permitted as a Permitted Investment, rather than as a Permitted Restricted Payment in order not to use-up capacity under the Net Income Builder basket.

An Issuer will want to provide that any investments made pursuant to a dollar-capped Permitted Investment basket over time that results in such entity becoming a Restricted Subsidiary will automatically be made under the "Investments in Restricted Subsidiaries" basket, thus refreshing the dollar-capped Permitted Investment basket.

An Issuer will also 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.

Classifying and Reclassifying Restricted Payments and Permitted Investments

If a Restricted Payment or Permitted Investment (or any portion thereof) meets the criteria of one or more categories of Permitted Restricted Payments or Permitted Investments, or is able to be incurred pursuant to the Net Income Builder basket, the Issuer is permitted to divide and classify such Restricted Payment or Permitted Investment (or any portion thereof) in any manner that complies with the Limitation on Restricted Payments covenant. Historically, unlike the Limitation on Indebtedness covenant, the Limitation on Restricted Payments covenant did not permit the Issuer to reclassify Restricted Payments or Permitted Investments at a later date.

However, what started out in only aggressive sponsor covenant packages has in recent years become more common, and now the ability to reclassify all or a portion of Restricted Payments or Permitted Investments at a later date has become relatively standard in high-yield covenant packages. Accordingly, as the Issuer grows its Net Income Builder basket over time, it will be able to reclassify Permitted Restricted Payments or Permitted Investments as having been incurred under the Net Income Builder basket, and thereby refresh the dollar-capped Permitted Restricted Payments and Permitted Investment baskets. The same holds true if the Issuer is able to negotiate a Leverage Ratio

Permitted Restricted Payments basket; once the Issuer satisfies the leverage ratio test, the Issuer is able to deem all Restricted Payments and Permitted Investments that have been made since the issue date of the bonds, as well as Restricted Payments that were incurred pursuant to the Net Income Builder basket, as having been made pursuant to the Leverage Ratio basket, and thereby refreshing all dollar-capped baskets and the Net Income Builder basket.

Other Covenants To Consider

A guarantee of the indebtedness of others needs to be evaluated as both the incurrence of indebtedness and the making of an investment. Therefore, prior to providing a guarantee, the Issuer must make sure availability, or an available carve-out, exists under the Limitation on Restricted Payments covenant and the Limitation on Indebtedness covenant.

Limitation on Restrictions on Dividends and Other Payments From Restricted Subsidiaries

This covenant (often called the "**Limitation on Dividend Stoppers Covenant**") prevents cash flow needed to service debt of the Issuer from being trapped at a subsidiary level (*i.e.*, bondholders want all cash generated by Restricted Subsidies to be able to freely flow up to the Issuer so that it may be used to satisfy obligations under the bonds). As such, the covenant is a general prohibition on the existence of any restriction on the ability of any Restricted Subsidiary (alternately, sometimes limited to only non-Guarantor Restricted Subsidiaries) 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 already in existence on the issue date of the boards, including those arising under existing indebtedness;

- restrictions in refinancings of existing indebtedness, if the limitations are not more restrictive than those being refinanced;
- restrictions in any other indebtedness permitted to be incurred under the Limitation on Indebtedness covenant, *provided* (x) such restrictions will not materially adversely affect the Issuer's ability to make principal or interest payments on the bonds as and when they come due (as determined in good faith by the Issuer) or (y) such restrictions apply only during the continuance of a default in respect of a payment or financial maintenance covenant relating to such indebtedness;
- restrictions already in place when a subsidiary is acquired (provided such restrictions are not incurred in anticipation of such acquisition);
- applicable law; and
- customary lease provisions.

Joint ventures entered into by the Issuer or its Restricted Subsidiaries may present obstacles in the context of this covenant, 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% 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 subject to the requirements of the Limitation on Restricted Payments covenant. Regardless, careful attention should be paid to the Issuer's past and expected use of joint venture arrangements to conduct its business.

Other Covenants To Consider

The Limitation on Dividend Stoppers covenant should be reviewed in conjunction with the Limitation on Indebtedness covenant since indebtedness that otherwise may be incurred under the Limitation on Indebtedness covenant 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, unless there is a suitable carve-out, like the one described in the third bullet point above.

Limitation on Liens

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

An example of the covenant is provided below.

> *Section 4.07. Limitation on Liens.*
>
> *a. The Issuer will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, incur, assume or permit to exist any Lien on any of assets or properties of the Issuer or any Restricted Subsidiary, whether owned at the issue date or thereafter acquired, to secure Indebtedness except Permitted Liens, unless the Notes are equally and ratably secured by such Lien.*

Similar to other high-yield covenants, however, the exceptions contained in the definition of Permitted Liens must be carefully reviewed to ensure it covers all existing secured debt, as well as sufficient flexibility to address the Issuer's future financing needs that may need to be secured within reasonable parameters that are acceptable to investors.

“**Permitted Liens**” typically include:

- Liens securing indebtedness permitted under the Credit Facility basket;
- Liens security Purchase Money Indebtedness, provided such liens are only on the assets acquired, constructed or improved;
- Liens on acquired property that were not incurred in contemplation of the acquisition;
- Liens securing secured Permitted Refinancing Indebtedness, provided the liens are only on the same assets that secured the debt being refinanced;
- Liens existing on the issue date that are not otherwise included within any other Permitted Lien exception;
- Liens securing other indebtedness subject to a dollar cap (which is generally a relatively small dollar amount); and
- Liens securing other indebtedness provided at the time of incurrence of such indebtedness a secured leverage ratio (*i.e.*, the ratio of the total amount of secured indebtedness of the Issuer and its Restricted Subsidiaries to Consolidated EBITDA) is satisfied on a *pro forma* basis.

PRACTICE TIP

Care should be exercised when drafting the Permitted Lien Credit Facility basket, which in some cases (intentionally or unintentionally) is drafted as “Liens securing Indebtedness under any Credit Facility” without referencing the dollar-capped Credit Facility debt basket. Such a loophole would enable virtually all debt permitted to be incurred under the Limitation on Indebtedness covenant to be secured.

If the bonds are not guaranteed by all of the Issuer's Restricted Subsidiaries, the Issuer and its counsel should be sure the definition of Permitted Liens includes the following Permitted Lien: "Liens on property of any Restricted Subsidiary that is not a Guarantor securing indebtedness or other obligations of such Restricted Subsidiary or any other Restricted Subsidiary that is not a Guarantor." To the extent investors are comfortable with debt being incurred by Restricted Subsidiaries that are not Guarantors pursuant to the Limitation on Indebtedness covenant, then Investors should not have any issue with this Permitted Lien basket, since the bonds are already structurally subordinated to the indebtedness and other obligations of such non-Guarantor Restricted Subsidiaries to the extent of the value of the assets held by such non-Guarantor Restricted Subsidiaries, whether or not such indebtedness or other obligations are secured.

Other Covenants To Consider

It is important to review this covenant in the context of the Limitation on Indebtedness covenant, because the incurrence of secured indebtedness requires a corresponding ability to incur the related Lien in the Permitted Liens definition.

Limitation on Asset Sales

Because sales of assets and subsidiary stock may result in income-producing assets being transferred outside the Credit Group, the Limitation on Asset Sales covenant limits external leakage, possibly deteriorating the Issuer's financial position by ensuring that certain procedural requirements are met in connection with sales of assets and subsidiary stock. As such, 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 consideration that may be received and specifies appropriate uses for the proceeds from such sales.

The definition of "**Asset Sale**" is typically broadly defined and will generally include traditional asset disposals and any direct and indirect sales of interests in Restricted Subsidiaries, including any issuance of capital stock of a Restricted Subsidiary to a third party or any disposition by means of a merger, consolidation or similar transaction. Moreover, the definition will include categories of asset disposals excluded from the definition and therefore do not need to satisfy conditions and requirements of the covenant, including (i) sales of inventory and other assets in the ordinary course of business, (ii) a carve-out for transactions below a specified dollar threshold, (iii) sales and transfers of assets between and among the Issuer and its Restricted Subsidiaries, (iv) sales or dispositions of worn-out or obsolete equipment, (v) transfers of assets constituting Permitted Investments or Restricted Payments permitted by the Restricted Payments covenant and (vi) licenses, leases and subleases in the ordinary course of business.

If a future asset sale is contemplated by the Issuer at the time of issuance, parties should consider providing a specific carve-out. However, such a carve-out should be evaluated against the cost and burden of compliance, given the largely administrative nature of the protection afforded to investors by this covenant.

As a covenant primarily focusing on ensuring proper safeguards on Asset Sales (and not forbidding such sales themselves), the Asset Sale covenant requires:

(1) The Issuer or the relevant Restricted Subsidiary to receive consideration at least equal to fair market value of the assets sold;

(2) At least a minimum percentage (typically 75%) of the consideration from the sale to be in the form of cash or "deemed cash";

- To add flexibility, issuers often request this percentage be based on the aggregate consideration received on all Asset Sales since the issue date of the bonds, rather than it being applied to each Asset Sale. While the definition of "deemed cash" is negotiated, it generally includes (i) unsubordinated debt assumed by the buyer, so long as the Credit Group is unconditionally released, and (ii) notes or other obligations or securities 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."

- Another type of "deemed cash" that has become very common is "Designated Non-Cash Consideration," which is non-cash consideration from Asset Sales designed as such by the Issuer pursuant to an officers' certificate delivered to the trustee for the bonds, which is subject to a dollar cap or the greater of a dollar cap and a "growth component" from all Asset Sales since the issue date of the bonds;

(3) 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) toward certain specified purposes that are generally favorable from a bondholder's point of view, including:

- To repay or repurchase debt that is structurally senior to the bonds, including (i) debt that is secured by a lien on the assets that are sold in the Asset Sale, (ii) any secured debt if the bonds are unsecured or, if the bonds are secured, debt that is secured by a lien that is senior to the lien securing the bonds or (iii) debt of any Restricted Subsidiary that is not a Guarantor of the bonds;
- To repay or repurchase debt that is not structurally senior and is *pari passu* with the bonds, provided a *pro rata* amount of bonds are concurrently redeemed or repurchased through open market purchases, privately negotiated transactions or pursuant to a tender offer at a purchase price that is not less than par *plus* accrued interest;
- To make capital expenditures or acquire assets that are used or useful in the business of the Issuer; or
- To acquire the stock of another entity in the same line of business that becomes a Restricted Subsidiary.

PRACTICE TIP

To avoid uncertainty regarding the need to segregate Asset Sale proceeds, Issuers will want to ensure the covenant directs the use of "cash equal in amount to the net cash proceeds from the Asset Sale," as opposed to the actual net cash proceeds. 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.

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 unused 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 with similar repayment requirements.

An example of the covenant is provided below.

Section 4.13. Limitation on Asset Sales.

(a) The Issuer will not, and will not permit any Restricted Subsidiary to, consummate any Asset Sale, unless:

(i) the consideration received by the Issuer or such Restricted Subsidiary, as the case may be, is at least equal to the Fair Market Value of the assets sold or disposed of; and

(ii) at least 75% of the consideration for such Asset Sale consists of:

(A) cash or Cash Equivalents;

(B) the assumption of Debt of the Issuer or such Restricted Subsidiary (other than Subordinated Debt) and release, by all applicable creditors in writing, from all liability on the Debt assumed;

(C) the assumption by the purchaser of Debt (other than Subordinated Debt) of any Restricted Subsidiary that is no longer a Restricted Subsidiary as a result of such Asset Sale, to the extent the Issuer and each Restricted Subsidiary are released by the purchaser in writing from any Guarantee of payment of such Debt in connection with such Asset Sale;

(D) Replacement Assets;

(E) Designated Non-cash Consideration; or

(F) any combination of the foregoing;

provided that the amount of any securities or assets received by the Issuer or such Restricted Subsidiary that is converted into cash within 180 days of the closing of such Asset Sale shall be deemed to be cash for purposes of this provision (to the extent of the cash received).

(b) Within 360 days after receipt of any Net Cash Proceeds from an Asset Sale, the Issuer (or any Restricted Subsidiary) may apply such Net Cash Proceeds to:

(i) permanently repay Secured Debt of the Issuer or a Subsidiary Guarantor or any Debt of a Restricted Subsidiary that is not a Subsidiary Guarantor (and, if such Secured Debt repaid is revolving credit Debt to correspondingly reduce commitments with respect thereto) in each case owing to a Person other than the Issuer or a Restricted Subsidiary;

(ii) to repay, repurchase or otherwise retire any Senior Debt of the Issuer or any Subsidiary Guarantor other than Debt owed to the Issuer or an Affiliate of the Issuer; provided that the

Issuer shall equally and ratably reduce obligations under the Notes, as provided under "— Optional Redemption," or through open market purchases, private transactions or otherwise, in each case at or above 100% of the principal amount thereof, or make an Asset Sale Offer (in accordance with the procedures described below);

(iii) to acquire Replacement Assets or make capital expenditures, provided that the Issuer or such Restricted Subsidiary will be deemed to have complied with its obligations under this paragraph if it enters into a binding commitment to acquire Replacement Assets prior to 365 days after the receipt of the applicable Net Cash Proceeds and such acquisition of Replacement Assets is consummated prior to 545 days after the date of receipt of the applicable Net Cash Proceeds; or

(iv) any combination of the foregoing.

(c) Any Net Cash Proceeds from Asset Sales that are not applied or invested as provided in Section 4.13(b) above will constitute "Excess Proceeds." Excess Proceeds of less than $10.0 million will be carried forward and accumulated. When accumulated Excess Proceeds exceed $10.0 million, within 10 days thereof, the Issuer must make an Offer to Purchase Notes having a principal amount equal to accumulated Excess.

Proceeds, multiplied by a fraction (x) the numerator of which is equal to the outstanding principal amount of the Notes and (y) the denominator of which is equal to the outstanding principal amount of the Notes and all pari passu *Debt similarly required to be repaid, redeemed or tendered in connection with the related Asset Sale.*

> *(d) The offer price in any Offer to Purchase will be equal to 100% of the principal amount of the Notes plus accrued and unpaid interest to the date of purchase, and will be payable in cash.*
>
> *(e) If any Excess Proceeds remain after consummation of an Offer to Purchase, the Issuer may use those Excess Proceeds for any purpose not otherwise prohibited by this Indenture. If the aggregate principal amount of Notes (and any other* pari passu *Debt) tendered in such Offer to Purchase exceeds the amount of Excess Proceeds, the Trustee will select the Notes (and such other* pari passu *Debt) to be purchased in accordance with the procedures set out under Section 3.02. Upon completion of each Offer to Purchase, the amount of Excess Proceeds will be reset at zero.*

Limitation on Transactions with Affiliates

The purpose of the Limitation on Transactions with Affiliates covenant is to avoid leakage from the Credit Group to controlling stockholders and other affiliates through transactions priced or structured on terms that are abnormally favorable to such affiliates, thereby potentially stripping value from the Credit Group. An affiliate is typically defined to include any person who controls, or is under common control with, the Issuer and sometimes includes any shareholder above a specified percentage (usually 10%).

This covenant provides a set of requirements that must be fulfilled but doesn't operate to prohibit affiliate transactions outright. Rather, it regulates such transactions (given potential risks of self-dealing involved) to prohibit the Credit Group from entering into transactions with any affiliate unless:

- the transaction is conducted on an arm's-length basis;

- if the transaction value exceeds a negotiated threshold amount (usually $1 million to $10 million, depending on the Issuer's size at the time the bonds are issued), 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 or accounting or appraisal firm (although often this approval is required only from a majority of disinterested directors of 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, salary, benefits, severance and indemnification arrangements to officers and 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, subject to a dollar cap.

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 as provided by the covenant. Because Unrestricted Subsidiaries are not subject to the indenture covenants, conditions that must be satisfied to designate a Restricted Subsidiary as an Unrestricted Subsidiary or to redesignate an Unrestricted Subsidiary as a Restricted Subsidiary are designed to prevent the Issuer's designations and redesignations as a way to potentially circumvent the otherwise applicable restrictions on investments, incurring indebtedness or engaging in acquisitions and dispositions.

By designating a subsidiary as unrestricted, the Issuer is deemed to have made an investment in the subsidiary in an amount equal to the fair market value of the Issuer's or its Restricted Subsidiary's interest in the subsidiary at the time of the designation. 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);
- 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 designated Unrestricted Subsidiary must not hold capital stock or indebtedness of, 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 Transactions with Affiliates covenant (*i.e.*, any agreement, transaction or arrangement between the Issuer and its remaining Restricted Subsidiaries, on the one hand, and the newly designated Unrestricted Subsidiary, on the other hand, must comply with the Limitation on Transaction with Affiliates covenant);
- The Issuer and its remaining Restricted Subsidiaries must not have any obligation to (i) subscribe for additional equity in the newly designated Unrestricted Subsidiary or (ii) maintain or preserve the financial condition of the newly designated 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 Limitation on Restricted Payments covenant (*i.e.*, any investment held by the newly designated Restricted Subsidiary must be able to be made in accordance with the Restricted Payments covenant or as a Permitted Investment);
- Any debt of the newly designated Restricted Subsidiary must be able to be made in accordance with the Limitation on Indebtedness covenant;
- Any liens on the newly designated 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 "**Merger 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 Merger covenant prohibits the Issuer from merging with or consolidating into another entity, or from transferring all or substantially all of the Credit Group's assets to another entity, unless the following general conditions are satisfied:

- either (x) the Issuer is the surviving entity or (y) the surviving entity is an entity organized under the laws of the United States of America, any State thereof or the District of Columbia (or, if the Issuer is a foreign entity, the jurisdiction under which the Issuer is organized) and the surviving entity expressly assumes the Issuer's obligations under the bonds and the indenture;
- either (x) the Issuer or the surviving entity must be able to incur at least $1.00 of Ratio Debt under the Limitation on Indebtedness covenant on a *pro forma* basis or (y) the Issuer's Fixed Charge Coverage Ratio on a *pro forma* basis is no worse than the Issuer's Fixed Charge Coverage Ratio before giving effect to the transaction; and
- the absence of a default, either before or as a result of the transaction.

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

a. 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. either the Subsidiary Guarantor is the surviving entity or the surviving entity is an entity organized under the laws of the United States of America, any State thereof or the District of Columbia (or, if the Subsidiary Guarantor is a foreign entity, the jurisdiction under which the Subsidiary Guarantor is organized) and expressly assumes the Subsidiary Guarantor's obligations under its guarantee of the bonds 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 bondholders from fundamental changes in the Issuer's ownership. 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' initial investment decision. This can be particularly true for portfolio companies of private equity sponsors that are repeat players in the high-yield markets. If significant changes in ownership occur during the life of the bonds, investors want the chance to exit the credit.

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 specified percentage (usually 101%) of their principal amount, *plus* accrued and unpaid interest to the date of repurchase. Specific Change of Control events can be heavily negotiated between the Issuer and the underwriters (especially where an initial public offering 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 specified percentage (generally 50%, but it can be as low as 30%) of the Issuer's voting capital; and

- dispositions of all or substantially all of the Credit Group's assets.

PRACTICE TIP

In addition to the primary equity owners of the Issuer, members of senior management of the Issuer and their respective heirs and affiliates, the definition of "Permitted Holders" should also include "any Person or group whose acquisition of beneficial ownership constitutes a Change of Control in respect of which a Change of Control Offer is made in accordance with the requirements of the indenture, together with its Affiliates."

Many Change of Control provisions will also include a "double trigger" to require that any Change of Control be accompanied by a ratings downgrade before the Change of Control put is triggered. The theory behind this additional requirement is that an ownership change without accompanying ratings decline may not negatively impact the bond price and, therefore, should not trigger an investor put right.

The occurrence of a Change of Control event represents a significant liquidity event for the Issuer and needs to be structured carefully and then monitored over the life of the bonds.

Reporting Covenant

The purpose of the Reporting covenant is to ensure the continuous availability of current information regarding 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 public disclosure for as long as the bonds are outstanding, whether or not the Issuer is subject to the reporting requirements of the U.S. Securities and Exchange Commission (the "**SEC**") or other reporting requirements.

Public availability of current information regarding the Issuer's financial performance is important not only for the development of a liquid market in the bonds, but it also protects bondholders 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 U.S. Federal Securities Law — Rule 144A.

There is also the recent issue of the application of SEC Rule 15c2-11 to fixed income debt securities, including high-yield bonds issued in Rule 144A and Regulation S offerings. Rule 15c2-11 generally prohibits broker-dealers from publishing or submitting securities of private issuers in a quotation medium other than a national securities exchange, such the over-the-counter ("**OTC**") markets, unless the Issuer has made current financial and other information publicly available as specified by the rule. Since the rule's inception, market participants had thought the rule only applied to equity securities in the OTC markets. Then, in a no-action letter issued in September 2021, the staff of the SEC confirmed a new and surprising interpretation of the rule, stating that the rule applies to all securities, including fixed income securities, despite never having been applied to or enforced in the fixed income securities markets. In response to concerns raised by market participants, the staff of SEC issued a no-action letter in November 2022 delaying implementation of Rule 15c2-11 until January 4, 2024 for private issuers of certain fixed income securities that trade in the OTC markets, including debt securities issued and traded in reliance on Rule 144A. In the event relief is not further extended or made permanent, the Reporting covenant in the high-yield covenant package will likely be tailored to address the requirements of Rule 15c2-11.

If the Issuer is already a public company in the U.S., the Reporting covenant will simply require the Issuer to provide to bondholders copies of the reports it files with the SEC pursuant to rules and regulations under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), in the manner and within the filing deadlines (*plus* a few days' grace period) required by such rules and regulations. Generally, such reports will be deemed provided to bondholders if such reports are publicly available on EDGAR.

However, if the Issuer is not a public company at the time the bonds are issued, the Issuer and its counsel should be careful the covenant is not drafted as a requirement to provide bondholders with annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K as if the Issuer were subject to the SEC's reporting requirements under the Exchange Act – a mistake that can happen to the unwary depending upon the precedent underwriters' counsel uses as a starting point in drafting the Description of the Notes section of the offering memorandum. Such a requirement would be overly burdensome for the Issuer, often resulting in the Issuer providing more information to investors going forward than what was included in the offering memorandum relating to the bonds. For such private Issuers, the Reporting covenant should provide for longer filing deadlines than the SEC requires (generally 90 to 120 days for annual reports and 60 days for quarterly reports), and either (i) expressly exclude certain "item requirements" of Form 10-K, 10-Q and Form 8-K that tend to be very technical and not material from a bondholder's perspective or (ii) draft the covenant as an obligation to provide bondholders with annual and quarterly reports "containing substantially the same information required to be contained in an annual report on Form 10-K or quarterly report on Form 10-Q, as the case may be, to the extent similar information is provided in the offering memorandum, including (A) "Management's Discussion and Analysis of Financial Condition and Results of Operations" and (B) audited or unaudited financial statements, as the case may be, prepared in accordance with GAAP." Furthermore, for private Issuers, the Reporting covenant sometimes allows the Issuer to make reports available on password-protected investor relations websites in lieu of having reports publicly available on EDGAR; such a provision, however, may become extinct if the relief in the application of Rule 15c2-11 to fixed income debt securities discussed above is not further extended or made permanent.

The Reporting covenant sometimes requires the Issuer to provide, within the reports provided to bondholders, a presentation of Consolidated EBITDA, as calculated under the indenture, for the most recent four fiscal quarters so investors may monitor covenant compliance and determine how much debt or Restricted Payment capacity the Issuer has remaining.

Many Reporting covenants also provide that, if the Issuer has any subsidiaries designated as Unrestricted Subsidiaries, then reports must also include a reasonably detailed presentation of the financial condition and results of operations of the Issuer and its Restricted Subsidiaries separate from the financial condition and results of operations of the Unrestricted Subsidiaries of the Issuer.

In addition to providing investors with annual, quarterly and current reports, in recent years, the Reporting covenant often requires the Issuer (particularly Issuers that are not public companies) to hold live quarterly conference calls with investors, including bondholders, to review the Issuer's latest earnings report and provide investors with an opportunity to ask questions of management.

PRACTICE TIP

It is not uncommon for companies to be delayed in issuing their financial statements, sometimes for reasons beyond their control. Some reasons include a change in GAAP, adoption of new accounting policies, significant acquisitions or delays in audit procedures. Issuers and their counsel should be sure to negotiate an extended grace period for breaches of the Reporting covenant before they become an Event of Default under the indenture. Grace periods for defaults under the Reporting covenant can be as long as 90 to 120 days, and sometimes longer.

Limitation on Business Activities

The aim of the Limitation on Business Activities covenant is to restrict the Issuer from entering into new lines of business that were not contemplated by bondholders at the time of issuance. For example, the covenant prohibits the Issuer from entering a business line that is (i) not the same type of business conducted by the Issuer and its subsidiaries as of the time of issuance (or reasonably related thereto) or (ii) not otherwise disclosed in the offering memorandum. Therefore, prior to negotiating the Limitation on Business Activities covenant, the Issuer must carefully consider its potential business lines over the life of the bonds while balancing such considerations against the investors' desire to limit the Issuer to lines of business and geographies where it has a proven track record.

Limitation on Guarantees of Indebtedness

The Limitation on Guarantees of Indebtedness covenant prevents the Issuer and its Restricted Subsidiaries from structurally subordinating the bonds to other indebtedness. The covenant does so by restricting non-guarantor Restricted Subsidiaries from guaranteeing, directly or indirectly, any indebtedness of the Issuer or any Subsidiary Guarantors unless it also guarantees the bonds on at least a *pari passu* basis with any such other indebtedness.

Use of Proceeds

The Use of Proceeds covenant requires the issuance proceeds to be used in the manner contemplated in the offering memorandum.

Payments for Consent

The Payments for Consent covenant requires that all offers of consideration in exchange for consents and waivers to indenture provisions must be made equally to all bondholders and that the consideration offered must be paid to all bondholders who consent.

This covenant almost never appears in sponsor deals and is on the verge of becoming extinct in high-yield covenant packages in the United States, regardless of the protests from such groups as Covenant Review that, in their reviews of covenant packages of high-yield bond offerings, repeatedly urge investors to demand the inclusion of this provision for their own protection. Their advice to investors, although mostly unheeded to date, is not unwarranted, as there have been a number of instances where Issuers have made significant amendments to the indenture (in some cases eliminating almost all of the restrictive covenants) by only negotiating with and getting the consent from (and only paying the consent fee to) bondholders that own 51% of the outstanding bonds.

High Yield Covenant Packages for REITs and Oil & Gas Companies

The high-yield covenant packages for companies in certain industries, particularly companies that are real estate investment trusts ("**REITs**") or that operate in the oil and gas industry, have been tailored differently from the standard high-yield covenant package in certain respects. This tailoring or deviation stems from the unique nature of these companies' revenue-generating assets, accounting principles related to the respective industry and how the covenants under their traditional debt facilities were structured. This section provides a brief overview of how the high-yield covenant packages for REITs and oil and gas companies differ from the standard high-yield covenant package discussed in the prior section of this Guide.

Differences in the High-Yield Covenant Package for REITs

The differences in the REIT high-yield covenant package from the standard high-yield covenant package were driven by traditional REIT investors, primarily insurance companies. Given the extent of their long-term liabilities, insurance companies were natural investors in commercial real estate through their underwriting of property-level mortgages, due to the long-lived nature of underlying assets. When a number of REITs began to explore the market for unsecured debt not backed by any specific asset owned by the REIT, insurance companies still wanted a covenant package similar to the property-level covenants typically found in commercial mortgages. In time, these investor requirements for a REIT bond issue began to coalesce into the standard REIT covenant package we have today.

Limitation on Indebtedness. As discussed in the prior section, the Limitation on Indebtedness covenant is structured as a general prohibition on the incurrence of any indebtedness by the Issuer or any of its Restricted Subsidiaries, unless either (x) the indebtedness can be incurred as "Ratio Debt," meaning a ratio test can be satisfied on a pro forma basis, which most often is a Fixed Charge Coverage Ratio (*i.e.*, the ratio of Consolidated EBITDA to Consolidated Interest Expense) of at least [2.0 – 2.5] to 1, or (y) the indebtedness to be incurred falls within one of the Permitted Indebtedness baskets. The Limitation on Indebtedness covenant for REITs is structured similarly; however, in order for the indebtedness to be incurred as the Ratio Debt, two ratio tests have to be satisfied (one of which is the Fixed Charge Coverage Ratio), and, if the indebtedness is secured, a third ratio test must be satisfied, as well as the Maintenance of Unencumbered Assets covenant, described below.

These three ratio tests are generally formulated as a prohibition on the incurrence of any indebtedness by the Issuer (which is always the operating partnership in the UPREIT structure and sometimes the parent REIT (essentially the holding company of the operating partnership) as co-issuer) and any of its Restricted Subsidiaries, unless, after giving effect to the incurrence of such indebtedness and the application of the proceeds therefrom:

(1) the aggregate principal amount of all outstanding indebtedness of the Issuer and its Restricted Subsidiaries would be no more than [60 – 65]% of Adjusted Total Assets of the Issuer and its Restricted Subsidiaries;

(2) the Fixed Charge Coverage Ratio would be at least 2.0 to 1; and

(3) if the indebtedness to be incurred is secured indebtedness, the aggregate principal amount of all outstanding secured indebtedness of the Issuer and its Restricted Subsidiaries would

be no more than [40 – 45]% of Adjusted Total Assets of the Issuer and its Restricted Subsidiaries.

"***Adjusted Total Assets***" is generally defined to mean, as of any date of determination, the sum of (1) in respect of any real estate assets that have been owned for the full four fiscal quarters immediately prior to such determination date, (x) the Consolidated EBITDA of such real estate assets during the most recently completed four fiscal quarters preceding such determination date *divided by* (y) the applicable Capitalization Rate;[6] (2) in respect of any real estate assets that have not been owned for the full four fiscal quarters immediately prior to such determination date, the cost (original cost *plus* capital improvements before depreciation and amortization) of such real estate assets and related intangibles; and (3) the book value of all other assets, excluding intangibles.

Maintenance of Total Unencumbered Assets. In lieu of the standard Limitation on Liens covenant and the long list of Permitted Lien baskets, many REIT high-yield covenant packages have a very brief and simple Maintenance of Total Unencumbered Assets covenant which requires the Issuer and its Restricted Subsidiaries to maintain Total Unencumbered Assets of not less than 150% of the aggregate outstanding principal amount of the unsecured indebtedness of the Issuer and its Restricted Subsidiaries on a consolidated basis. "***Total Unencumbered Assets***" is generally defined to mean the Adjusted Total Assets of such Person and its Restricted Subsidiaries that do not secure any secured indebtedness. This covenant is the exception to the rule that high-yield covenants are incurrence covenants rather than maintenance covenants. See above— "General Observations – Incurrence vs. Maintenance Covenants."

Limitation on Restricted Payments. With respect to the Limitation on Restricted Payments covenant, the main differences between the

[6] The Capitalization Rate is a percentage often in the range of 7.0% to 9.0%.

standard high-yield covenant package and REIT high-yield covenant package are found in the ratio test pre-condition in order to use the Net Income Builder basket and in the manner of calculating the Net Income Builder basket.

First, the Restricted Payments covenant for both the standard and the REIT high-yield covenant packages require the Issuer to be able to incur at least one dollar of Ratio Debt under the Limitation on Indebtedness covenant. Since the standard Limitation on Indebtedness covenant has only one test for the incurrence of Ratio Debt, which is generally the Fixed Charge Coverage Ratio, the Issuer only has to satisfy that test in order to avail itself of the Net Income Builder basket. Under the REIT Restricted Payments covenant, however, the Issuer must satisfy the two tests to incur unsecured Ratio Debt under the Limitation on Indebtedness covenant in order to use the Net Income Builder basket: (i) the Fixed Charge Coverage Ratio must be at least 2.0 to 1.0 *and* (ii) the aggregate principal amount of all outstanding indebtedness can't be greater than [60 – 65]% of Adjusted Total Assets.

Second, the starting point of the calculation of the Net Income Builder basket is different in the standard and REIT high-yield covenant packages. The standard Net Income Builder basket begins with 50% of the Issuer's cumulative Consolidated Net Income (or, if Consolidated Net Income is a loss, *minus* 100% of such loss) for the period from the beginning of the fiscal quarter during which the bonds are issued until the end of the most recent fiscal quarter for which financial statements are available. The REIT Net Income Builder basket, on the other hand, is calculated using 95% of the cumulative Funds From Operations for such period (or, if Funds From Operations is a loss, *minus* 100% of such loss). Funds From Operations is a supplemental financial metric used by REITs to measure operating performance and is endorsed by the National Association of Real Estate Investment Trusts ("NAREIT").

"***Funds From Operations***" is generally defined as the consolidated net income of the Issuer, as determined under GAAP after adjustments for unconsolidated partnerships and joint ventures, *plus* depreciation and amortization of real property (including furniture and equipment) and other real estate assets and excluding (1) gains or losses from (a) the restructuring or refinancing of indebtedness, (b) sales of properties or (c) changes in reserves for earnouts associated with any asset acquisition; (2) non-cash asset impairment charges (including write-offs of former tenant receivables); (3) fees and expenses incurred in connection with any acquisition or debt refinancing; (4) unrealized gains and losses from foreign currency transactions; (5) amortization of debt financing costs; and (6) all other non-cash charges, expenses, gains or losses.

Differences in the High-Yield Covenant Package for Oil & Gas Companies

Adjusted Consolidated Net Tangible Assets. The most significant difference in the high-yield covenant package for oil and gas companies – specifically "upstream" companies which are involved in the development, exploitation, production and acquisition of oil and natural gas reserves – is the calculation of the financial metric Adjusted Consolidated Net Tangible Assets (or "**ACNTA**"). Similar to the way the financial metric "Total Assets" is used in the standard high-yield covenant package, ACNTA is used in the high-yield covenant package for upstream O&G companies as the growth component (*e.g.,* "... the greater of $[X] million and [X]% of ACNTA") for various debt, Restricted Payments and Permitted Investment baskets, including the Credit Facility basket, the Purchase Money Indebtedness basket, the General Indebtedness basket, the General Restricted Payments basket, as well as the joint venture and general Permitted Investments baskets. However, ACNTA is calculated very differently than Total Assets, as determined under GAAP, and is generally formulated as:

(1) the sum of:

(a) the discounted future net revenues from Proved Reserves of the Credit Group calculated in accordance with SEC guidelines as estimated by the Issuer in a reserve report prepared as of the end of the Issuer's most recently completed fiscal year (or, if such date of determination is within 45 days after the end of such most recently completed fiscal year and no reserve report as of the end of such fiscal year has at the time been prepared or audited by independent petroleum engineers, the second preceding fiscal year) *or*, *at the Issuer's option*, the Issuer's most recently completed fiscal quarter for which financial statements are available, in each case which reserve report is prepared or audited by independent petroleum engineers as to Proved Reserves accounting for at least 80% of all such discounted future net revenues and by the Issuer's petroleum engineers with respect to any other Proved Reserves covered by such report, *as increased by* the estimated discounted future net revenues from:

(i) estimated Proved Reserves acquired since the date of such year-end or quarterly reserve report, as applicable, and

(ii) estimated Proved Reserves attributable to extensions, discoveries and other additions and upward revisions of estimates of Proved Reserves since the date of such year-end or quarterly reserve report, as applicable, the reserve report due to exploration, development or exploitation, production, or other activities that would, in accordance with standard industry practice, cause such revisions, and *decreased by* the discounted future net revenue attributable to:

(iii) estimated Proved Reserves reflected in such year-end or quarterly reserve report produced or disposed of since the date of such year-end or quarterly reserve report, as applicable, and

(iv) reductions in estimated Proved Reserves reflected in such year-end or quarterly reserve report since the date of such year-end or quarterly reserve report attributable to downward revisions of estimates of Proved Reserves since the date of such year-end or quarterly reserve report, as applicable, due to changes in geological conditions or other factors that would, in accordance with standard industry practice, cause such revisions;

in the case of the preceding clauses (i) through (iv), calculated on a pre-tax basis in accordance with SEC guidelines (<u>utilizing the prices utilized in the Issuer's year-end or quarterly reserve report, as applicable</u>) and estimated by the Issuer's petroleum engineers or any independent petroleum engineers engaged by the Issuer for that purpose;

(b) the capitalized costs attributable to oil and gas properties of the Credit Group to which no Proved Reserves are attributable;

(c) the Consolidated Net Working Capital of the Credit Group; and

(d) the greater of (i) the net book value and (ii) the appraised value, as estimated by independent appraisers, of other tangible assets, in each of clauses (b), (c) and (d) as of the last day of the Issuer's most recent annual or quarterly period for which internal financial statements are available;

minus, to the extent not otherwise taken into account in this clause (1),

(2) the sum of:

(a) minority interests;

(b) any net gas balancing liabilities of the Credit Group as of the last day of the Issuer's most recent annual or quarterly period for which internal financial statements are available;

(c) to the extent included in clause (1)(a) above, the discounted future net revenues, calculated on a pre-tax basis in accordance with SEC guidelines (<u>utilizing the prices and costs utilized in the applicable reserve report described in clause (1)(a)</u>), attributable to reserves that are required to be delivered to third parties to fully satisfy the obligations of the Credit Group with respect to Volumetric Production Payments; and

(d) the discounted future net revenues, calculated on a pre-tax basis in accordance with SEC guidelines, attributable to reserves subject to Dollar-Denominated Production Payments that, based on the estimates of production, price and cost assumptions included in determining the discounted future net revenues specified in clause (1)(a) above, would be necessary to fully satisfy payment obligations of the Credit Group with respect to Dollar-Denominated Production Payments.

Similar to the idea behind a growth component based on a percentage of an Issuer's Total Assets, the basic theory behind a growth component based on a percentage of an Issuer's ACNTA is that an Issuer's debt incurrence capacity scales as the asset base expands and contracts as the asset base shrinks. However, the methodology behind the two financial metrics is very different. Total Assets in the standard high-yield covenant package is generally defined as the total assets of the Issuer and its Restricted Subsidiaries as shown on the consolidated balance sheet of the Issuer as of the most recently completed fiscal quarter for which internal financial statements prepared in accordance with GAAP are available. With the exception of certain assets that are required to be valued at their fair market value as of the end of the most recent fiscal quarter (such as publicly traded securities held for investment), most of the assets that comprise Total Assets will be valued at their original cost less accumulated depreciation and amortization, thereby constituting in many situations a more "stable" asset base.

The definition of ACNTA, on the other hand, values the most important assets of oil and gas companies (*i.e.,* their proven oil and gas reserves) based on their discounted future net revenues calculated in accordance with SEC guidelines as estimated by the Issuer in a reserve report prepared as of the end of the Issuer's most recently completed fiscal year *or*, *at the Issuer's option*, the Issuer's most recently completed fiscal quarter for which financial statements are available. Oil and gas prices are constantly changing, and, as we have all experienced recently, they can change drastically over a short period of time. The optionality provided by the definition of ACNTA in the ability of the Issuer to choose the prices utilized in the Issuer's year-end or most recent quarterly reserve report (*see* the underlined language in clauses 1(a) and 2(c) of the definition of ACNTA above) can be a significant advantage to an Issuer in a declining price environment (while allowing for upward adjustment in an increasing price environment), because it allows for backward-looking price consideration and applies such pricing forward on a constant basis through the next year. There are legitimate business reasons related to the expensive and lengthy reserves development process and indebtedness necessary to finance such development, but this material difference in the high-yield covenant package should be carefully evaluated by parties to a specific transaction.

Let's create a hypothetical situation to see this in practice: The price per barrel of oil used by an Issuer in its 2022 year-end reserve report was based on market pricing at the time was $90 per barrel. During 2023, a global recession occurs, and the price of oil at the end of the third quarter drops to $50 a barrel. During the fourth quarter of 2023, the Issuer wants to incur indebtedness using a Permitted Indebtedness basket that has a growth component based on a percentage of ACNTA. Under the definition of ACNTA, the Issuer has the ability to calculate the discounted future net revenues of its proven reserves (including any proven reserves acquired or brought online after December 31, 2022) at the $90 per barrel pricing, despite the interim material price decline that could adversely impact the actual value of its reserves.

Frequent Use of Issuer-Friendly Provisions. Over the past decade, as oil prices rose, covenants in high-yield bonds for oil and gas companies became increasingly Issuer-friendly. This trend was exacerbated by increased sponsor involvement in the industry. Such sponsors brought more aggressive Issuer-side high-yield covenant approaches and applied them to oil and gas portfolio companies, gradually changing the available market precedents and resetting what is considered "market" for oil and gas Issuers. Many (and often times most) of the Issuer-friendly sponsor-driven provisions discussed in the prior section, "The High-Yield Covenant Package," can be found in the high-yield covenant package for oil and gas issuers. Some of these Issuer-friendly provisions specific to the oil and gas industry are discussed below.

Permitted Business Investments. Most oil and gas high-yield covenant packages include a Permitted Investment basket for "Permitted Business Investments." It is essentially an uncapped Permitted Investment basket for joint ventures, as long as the joint venture operates in the oil and gas business. Due to the historical and customary nature of risk-share, operational and financing arrangements in the oil and gas industry, such a basket is generally necessary and is accepted by high-yield investors. A typical Permitted Business Investment definition reads as follows:

> "*Permitted Business Investments*" means Investments made in the ordinary course of, or of a nature that is or shall have become customary in, the Oil and Gas Business as a means of actively

exploiting, exploring for, acquiring, developing, processing, gathering, marketing or transporting oil and natural gas through agreements, transactions, interests or arrangements which permit one to share risks or costs, comply with regulatory requirements regarding local ownership or satisfy other objectives customarily achieved through the conduct of Oil and Gas Business jointly with third parties, including, without limitation, (i) ownership interests in oil, natural gas, other Hydrocarbon properties or any interest therein or gathering, transportation, processing, storage or related systems, (ii) entry into and Investments and expenditures in the form of or pursuant to operating agreements, processing agreements, farm-in agreements, farm-out agreements, development agreements, area of mutual interest agreements, unitization agreements, pooling agreements, joint bidding agreements, service contracts, joint venture agreements, partnership agreements (whether general or limited), subscription agreements, stock purchase agreements and other similar or customary agreements, (iii) working interests, royalty interests, mineral leases, production sharing agreements, production sales and marketing agreements, oil or gas leases, overriding royalty agreements, net profits agreements, production payment agreements or royalty trust agreements, (iv) Investments of operating funds on behalf of co-owners of properties used in the Oil and Gas Business of the Company or its Restricted Subsidiaries pursuant to joint operating agreements, and (v) direct or indirect ownership interests in drilling rigs, fracturing units and other related equipment.

Limitation on Asset Sales.

Carve-outs to the Definition of Asset Sale. Since Permitted Investments (along with Restricted Payments permitted under the Limitation on Restricted Payments covenant) are generally carved-out of the definition of Asset Sale, the Permitted Business Investments basket provides the Issuer with a lot of flexibility to transfer revenue generating assets outside the Credit Group without having to comply with the Limitation on Asset Sales covenant. Another carve-out that is particular to oil and gas companies is the exclusion for "undeveloped acreage" or "properties to which no proved reserves are associated" or even "proved reserves not capable of being produced in material economic quantity." Such carve-outs, if significant, might cause bondholders to question whether consideration for such sales should be subject to the Asset Sales covenant. The exclusion of assets considered "no longer used or useful" or "obsolete" raises a similar question because there typically is not a value ceiling on such transfers or dispositions.

Non-Cash Consideration as a Permitted Investment. Many O&G high-yield covenant packages modify the typical inclusion, as a Permitted Investment, "non-cash consideration permitted to be received in connection with an Asset Sale made in compliance with the Asset Sales covenant." This inclusion is designed to allow for the 25% non-cash consideration typically permitted by the Asset Sales covenant. However, modification of this language to apply to "any Asset Swap or other non-cash consideration received for a disposition not constituting an Asset Sale" removes any limitation from any non-cash disposition.

Services as Permitted Consideration. Many O&G high-yield covenant packages provide that the obligation of the transferee (or its affiliate) to pay for exploration and operating expenses of transferred property qualifies as "deemed cash" consideration where the Issuer or a Restricted Subsidiary retains an interest in such property.

Application of Asset Sale Proceeds. Many O&G high-yield covenant packages allow Net Proceeds from Asset Sales to net any indebtedness that by its terms must be paid with such proceeds, and any other indebtedness that must be paid in order to obtain a necessary consent for such Asset Sale, thereby potentially repaying *pari passu* ahead of the bonds.

Legal Considerations

Governing 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 bondholders. Extensive New York case law provides both the Issuer and the bondholders with a relative degree of certainty regarding the interpretation of the high-yield covenants and legal issues associated with the bonds and the indenture. This depth of applicable case law, which serves as a robust interpretative protection in a default or dispute, means that New York law remains the preferred choice of governing law for high-yield bonds.

Transaction Structure and U.S. Federal Securities Law

Section 5 of the United States 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 SEC and becomes effective or unless an exemption from such registration requirements 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."[7]

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 pursuant to 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 U.S. exchange or quoted on a

[7] For a variety of reasons, including the relative simplicity of a private placement sometimes 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 has been previously filled with, and declared effective by the SEC).

U.S. 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% 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 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, due diligence exercises conducted by the working group in a Rule 144A transaction are robust and very similar to the 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 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.

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 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.

PRACTICE TIP

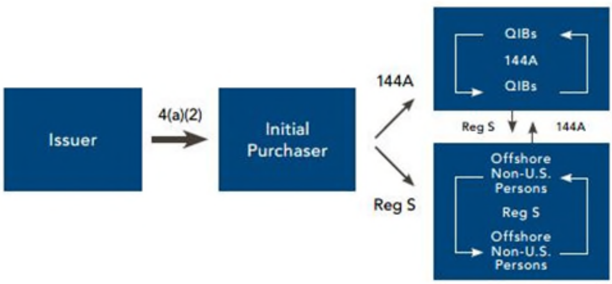
It is important to determine with the underwriters as early as possible whether a transaction will be structured as a Regulation S-only or Regulation S/Rule 144A offering, as this offering structure will impact the due diligence and disclosure requirements, among other things, and the overall transaction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

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 Regulation S flowing back into the U.S. market. The three categories of transactions, each with its own set of requirements under Regulation S are:

- Category 1 (*least restrictive*): Category 1 transactions include offerings of securities by foreign issuers that reasonably believe at the commencement of the offering that there is no substantial U.S. market interest ("**SUSMI**") with respect to the relevant securities to be offered or sold; securities offered and sold by either a "foreign issuer" or, in the case of non-convertible debt securities, a U.S. issuer, in an overseas directed offering; securities backed by the full faith and credit of a foreign government or sovereign, including securities issued directly (or guaranteed) by a foreign government or sovereign or a political subdivision thereof; and securities by foreign issuers pursuant to an employee benefit plan established under foreign law. For these transactions, it is unlikely the securities offered will flow into the U.S. market and no other requirements need to be met other than the Regulation S basic conditions;
- Category 2: Category 2 transactions include offerings of equity securities of a reporting foreign issuer; debt securities of a reporting U.S. or foreign issuer; and debt securities of a non-reporting foreign issuer. For these transactions, certain 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*): Category 3 transactions include transactions not eligible for Category 1 or Category 2. For

these transactions, existing potential U.S. market interest is sufficient enough (*i.e.*, there is SUSMI 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 Category 2 restrictions must be adopted (with further distribution compliance period restrictions) and certain purchaser certifications and others restrictions must be satisfied.

Set forth below is a diagram of common transaction structures and the relevant U.S. securities law exemptions.



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 bondholders 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, bondholders 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 was 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 agreed 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 (i) file a registration statement on Form S-4 registering the A/B exchange offer within a certain period of time following the issuance of the original bonds, (ii) have the registration statement declared effective by the SEC within an additional number of days and (iii) consummate the exchange offer within a certain number of days or otherwise be subject to penalties in the form of additional interest until the applicable default is remedied. The time period to consummate the exchange offer varies greatly (from 120 days to 365 days or longer, depending on whether or not the Issuer is already a reporting company).

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 flow of financial and other information mandated by the SEC to the bondholders 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 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 is not 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 (the "**TIA**"). The purpose of the TIA is to protect bondholders 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 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 which can be cumbersome and expensive, particularly for first-lien secured bonds.[8]

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8 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

The securities laws of many jurisdictions, in particular, the United States, 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, 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.

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.

The release of information that is inaccurate, misleading or inconsistent with the offering memorandum is undesirable, as it may cast doubt on accuracy of the offering memorandum. Failure to observe publicity requirements may result in registration or similar requirements under the securities laws of various jurisdictions 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 without consulting with legal counsel and the working group.

To ensure compliance with all applicable securities laws and regulations, Issuer’s counsel will prepare publicity guidelines at the outset of a proposed offering. 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 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 publicity guidelines, it is advisable to appoint one Issuer representative to serve as the initial point of contact for press and securities analysts and to handle publicity and other broad-based communications during the offering process.

Transaction Execution

Pre-Launch

Under ideal circumstances, and with the full commitment of all parties involved in the offering, 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 which cause delays include: (i) the lack of existing, high-quality disclosure language (in English) 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 bondholders); (v) delays and complications in the rating process; (vi) third-party KYC procedures; and (vii) general market conditions.

The following table details a typical pre-launch timeline:

Time	*Tasks*
Week 1	• Issuer's counsel prepares initial draft of offering memorandum outline and discusses it with Issuer. • Issuer, underwriters and their respective counsels agree to the offering structure. • Issuer and Issuer's counsel discuss covenant package. • Issuer's counsel discusses covenant concerns with underwriters. • If bonds are secured, Issuer, underwriters and their respective counsels agree to approach with respect to existing lenders and security trustee. • Issuer prepares data room in response to due diligence request list provided by underwriters' counsel. • Underwriters circulate management due diligence questionnaire. • Issuer's counsel circulates publicity guidelines. • Underwriters' counsel circulates research guidelines (if Issuer is a public company).
Week 2	• Issuer circulates management presentation to working group. • Issuer's counsel distributes first draft of the offering memorandum to the underwriters and their counsel. • Issuer's counsel and underwriters' counsel commence documentary due diligence. • Underwriters and underwriters' counsel draft the Description of the Notes section of the offering memorandum (the "**DoN**") and the purchase agreement.

Time	*Tasks*
Week 3	• Select trustee. • Underwriters' counsel circulates draft of the DoN. • Underwriters and their counsel review draft offering memorandum and prepare consolidated mark-up. • Issuer and Issuer's counsel discuss the DoN. • Drafting session on the offering memorandum. • Underwriters counsel prepares circle-up of financial numbers in the offering memorandum for the comfort letter and sends to Issuer's accountants. • Accountants prepare draft of comfort letter and circulate to working group. • Underwriters and underwriters' counsel circulate draft of the purchase agreement. • Issuer and underwriters prepare rating agency presentation.
Week 4	• Issuer's counsel re-circulates draft of the offering memorandum to working group. • Underwriters and their counsel review the offering memorandum and prepare consolidated mark-up. • Issuer's counsel circulates mark-up of the DoN. • Underwriters, Issuer and their respective counsels discuss the DoN. • Drafting session on the offering memorandum. • Issuer and Issuer's counsel discuss purchase agreement and circulate mark-up to underwriters and underwriters' counsel. • Underwriters' counsel and accountants discuss comfort letter and circle-up. • Issuer and underwriters prepare rating agency presentation.

Time	*Tasks*
Week 5	• Drafting session on the offering memorandum. • Discussions on the DoN. • Discuss purchase agreement, if necessary. • Issuer and underwriters prepare rating agency presentation. • Work on road show presentation.
Week 6	• Continued negotiations on the DoN. • Drafting session on the offering memorandum. • Discuss purchase agreement, if necessary. • Meetings with rating agencies. • Work on road show presentation. • Underwriters' counsel finalizes the DoN.
Week 7	• Issuer's counsel finalizes preliminary offering memorandum. • Finalize purchase agreement. • Finalize comfort letter. • Finalize road show presentation. • Any necessary lender consents obtained. • Receive preliminary feedback from rating agencies. • Print preliminary offering memorandum and launch offering.

Time	Tasks
Week 8	• Road show generally lasts 3 – 5 business days. • Underwriters' counsel distributes drafts of indenture and any security documents. • Deal is priced and term sheet is sent to investors to confirm orders. • Purchase Agreement is signed and comfort letter is delivered. • Closing occurs within 2 – 5 business days. • Closing documents are signed and delivered, including indenture, bonds, security documents (if any), bring-down comfort letter, opinions and other closing documents. • Underwriters wire funds to Issuer, and bonds are delivered to underwriters via DTC.

The Due Diligence Review

General Guidelines

In order to better understand the business of the Issuer and to assist in drafting an accurate and meaningful offering memorandum, the lead underwriters, their counsel and the Issuer's counsel simultaneously conduct an extensive review of the legal, business and financial aspects of the Issuer's operations. This typically entails a review of all material contracts, governmental authorizations and other key documentary aspects of the business. In addition, the parties conduct a series of discussions with the Issuer's senior management, its financial staff and its independent accountants.

The extent of due diligence required varies from case to case, depending on the circumstances, and inevitably involves judgment calls. Information received during the due diligence process facilitates the drafting process and helps to ensure all material aspects of the Issuer's business are properly disclosed. The due diligence exercise also helps to ensure disclosure contained in the offering memorandum is accurate and based on the most current data available.

Conducting Due Diligence

The due diligence exercise can be broadly categorized into legal, business and financial due diligence. The diligence exercise is typically led by the underwriters' legal counsel in conjunction with the Issuer's legal counsel, which assists the Issuer in responding to the questions.

A legal due diligence review includes a review of the Issuer's corporate structure, charter documents, minutes of board and committee meetings, shareholder information, presentations and reports from the Issuer, the Issuer's debt agreements, agreements with related parties, agreement with major customers and suppliers, other material agreements and documentation relating to the Issuer's intellectual property, material litigation, regulatory compliance, environmental issues and other contingent liabilities. Underwriters and their counsel provide the Issuer with a list of documents they would like to review in preparation of the offering memorandum. This due diligence request list is comprehensive and broad. As the requesting party is not fully apprised of the Issuer's documentation, the list necessarily includes items an underwriter would normally expect to find in the data room of a similar company in a similar industry.

After receiving a diligence request list, the Issuer begins preparing a data room containing documents responsive to the diligence request list, as well as any documents not on the diligence request list but deemed by the Issuer to be material. Location of the data room itself varies based on the location of the documents and parties that need to review the documents. For most Issuers, it is more efficient and economical to make the documents available for review via a secure, password-protected website, accessible only to those parties involved in the offering. For certain Issuers, it is most efficient and economical to create a space at their place of business where all documents can be set aside for review.

The Issuer's legal counsel can assist the Issuer's management team to interpret the due diligence request list, as well as provide advice regarding how to best organize the materials for the working group.

Financial due diligence involves the Issuer's finance, accounting and treasury departments. It typically includes a review of the Issuer's full year and interim financial statements, results of operations, projections, cash-flow, financial indebtedness and other aspects of the Issuer's financial condition. Underwriters and their counsel focus their review on factors driving the Issuer's finances, and significant changes in the Issuer's financial position from period to period. In addition, financial due diligence focuses on the Issuer's profit and working capital forecasts. It is also customary to have a due diligence meeting with the Issuer's external auditors to discuss, among other things, auditor independence from the Issuer, any problems identified during the audit and comments on the Issuer's internal accounting policies, controls and procedures. Particular attention will be placed on accounting policies where discretion or judgment of the senior management team can be applied with a goal of understanding whether the application of discretion has been reasonably applied.

During the due diligence process, business due diligence sessions are conducted with senior management of the Issuer. These sessions focus on the Issuer's business and growth strategies; competitive landscape and industry outlook; the Issuer's financial performance, especially key drivers of revenue and profitability; the Issuer's capitalization, cash-flow and liquidity; the Issuer's corporate structure and organization; material risks to the Issuer's business; material litigation and contingent liabilities; regulatory issues and other issues which could have a material impact on the Issuer's business. These meetings afford the underwriters and both sets of legal counsel the opportunity to understand the Issuer's business through the eyes of management, which assists in the drafting of the offering memorandum and ensuring the information in the offering memorandum is accurate and complete and does not contain a material misstatement or omission.

"Rule 10b-5 Letter"

The due diligence review also serves to establish a record that the underwriters have made a reasonable investigation upon which their defense against potential liability can be based. Offerings made under Rule 144A and Regulation S are exempt from the registration requirements of the Securities Act, but remain subject to the anti-fraud provisions of the Securities Act and the Exchange Act, including Rule 10b-5. However, the exercise of reasonable care, in the form of a carefully conducted due diligence investigation, can be used as an affirmative defense by certain persons (notably, the underwriters and the Issuer's Board of Directors) to refute the existence of an intent to defraud, deceive or manipulate. As a result, underwriter due diligence has become a critical component of a defense to liability for offerings conducted pursuant to Rule 144A. To that end, underwriters customarily request both sets of legal counsel to issue a so-called "Rule 10b-5 disclosure letter" to help them document such defense. A Rule 10b-5 disclosure letter is a letter from legal counsel addressed to the underwriters (and, in the case of the Issuer's legal counsel, the Issuer's Board of Directors) confirming they have undertaken certain procedures and, on that basis, have no reason to believe the offering memorandum contains an untrue statement of material fact, or omits to state a material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading.

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 registered 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.

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) a description of the Issuer's business (including business strategies and competitive strengths), (ii) a summary of the terms of the bonds being offered and (iii) summary financial data.
- ***Risk factors***: The risk factors section specifies risks associated with the Issuer and its industry and risks related to the bonds and the private placement. Risk factors are often similar to risk factors found in offering memoranda and prospectuses of other Issuers in the same industry and are tailored to describe specific risks associated with the company conducting the present offering. Per guidance from the SEC, 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 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 U.S. generally accepted accounting principles (GAAP) or, for foreign issuers, international financial reporting standards (IFRS) or the Issuer's home country's GAAP), 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 not subject to the reporting requirements of the Exchange Act or that have not prepared 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 which 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 recently acquired or that it is probable the Issuer will acquire if the acquired company meets any of the three significance tests:

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

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

Additionally, Article 11 of Regulation S-X requires the Issuer to 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 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, as well as a *pro forma* income statement for the most recent fiscal year and the most recent interim period.[9]

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 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.

In the case of bonds that are guaranteed by some or all the Issuer's Restricted Subsidiaries or its parent company, the SEC views each guarantee as a separate security and, without the benefit of an exemption, would require historical financial statements of each guarantor to be included in the prospectus for the bonds. Rule 3-10 of Regulation S-X, which was amended in March 2020, allows the registrant to omit separate subsidiary issuer or guarantor financial statements in the prospectus and include only the financial statements of the parent company issuer or guarantor if the following conditions are satisfied: (i)

[9] For a more detailed discussion of the significance test and the requirements for separate financial statements of the acquired or target company and related pro forma financial statements under Rule 3-05 and Article 11 of Regulation S-X, see Mayer Brown's *On Point*. article, "Target and Pro Forma Financial Statement Requirements for Significant Acquisitions," available here: bit.ly/3vEwntx.

the consolidated financial statements of the parent company have been filed with the SEC, (ii) the subsidiary issuer or guarantor is a consolidated subsidiary of the parent company, (iii) either (x) the parent company issues the debt security or co-issues the debt security, jointly and severally, with one or more of its consolidated subsidiaries or (y) the consolidated subsidiary issues the debt security or co-issues the debt security with one or more other consolidated subsidiaries of the parent company, and the debt security is guaranteed fully and unconditionally by the parent company and (iv) the prospectus includes certain financial and non-financial disclosures specified by Rule 13-01 of Regulation S-X to the extent material. With respect to financial disclosures, Rule 13-01 requires "summarized financial information" (as defined in Rule 1-02(bb)(1) of Regulation S-X) for the issuer and the guarantors (excluding subsidiaries that are not issuers or guarantors), which includes select balance sheet and income statement line items for the most recent fiscal year and year-to-date interim period (along with an accompanying note that briefly describes the basis of the presentation) and may be presented for the issuer and the guarantors on a combined basis. In regards to the non-financial information, Rule 13-01 requires qualitative disclosures about the issuers and the guarantors, the terms and conditions of the guarantees, how the issuer-guarantor structure and other factors may affect payments to the holders of the debt securities and any financial and narrative information about each guarantor if the information would be material for investors to evaluate the sufficiency of the guarantee.

Furthermore, if the bonds being registered are secured by a pledge of securities of any the registrant's affiliates, similar to S-X Rules 3-10 and 13-01, Rule 13-02 of Regulation S-X requires the registrant to include in the prospectus certain financial and non-financial disclosures with respect to such affiliates and the pledge, in each case, to the extent material. For the financial disclosures, Rule 13-02 requires inclusion of summary financial information for each such affiliate that is consolidated in the registrant's financial statements, which may be presented on a combined basis for all such affiliates, and is similar to the summary financial information required for subsidiary issuers and guarantors under Rule 13-01 discussed above. For the non-financial disclosures, Rule 13-02 requires (i) a description of the securities pledged as collateral and the affiliates whose securities are pledged as collateral, (ii) a description of the terms and conditions of the collateral arrangement, (iii) a description of the trading market for the pledged securities or a statement that there is no market and (iv) any other financial and narrative information about each such affiliate if the information would be material for investors to evaluate the pledge of the affiliate's securities as collateral.[10]

- *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. MD&A discussion will analyze and address the Issuer's financial performance on a period-by-period comparison basis and explain 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 specific to the Issuer's business.
- *Management Overview*: 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.

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[10]For a more detailed discussion of Rules 3-10, 3-16 and 13-01 of Regulation S-X, *see* Mayer Brown's Legal Update, "SEC Amends Financial Disclosure Requirements in Registered Debt Offerings involving Guaranteed or Collateralized Securities," here: bit.ly/3GFw1ZR.

- *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*: The DoN discusses specific terms and conditions of the bonds (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 and technical assessments may also be included in the offering memorandum.

Indenture

The indenture is the contract entered into among the Issuer, any guarantors and the trustee. It includes all of the terms of the bonds, including interest rate, maturity date and the bond covenants. Terms of the indenture are summarized in the section captioned "Description of the Notes" of the offering memorandum, but post-issuance the indenture represents the central legal contract governing the bonds.

We receive numerous questions from Issuers regarding the role of the trustee. Put simply, a trustee is appointed by the Issuer to represent the bondholders' interests and to administer various matters which may arise from time to time while the bonds are outstanding. These matters include purely administrative functions, such as coordinating payments and receiving compliance certificates. In a pre-default scenario, the trustee will simply handle the functions of paying agent, transfer agent and registrar for the bonds. For liability management exercises, in which a consent from bondholders is needed or other communication with the bondholders becomes necessary, the trustee may be engaged to assist the Issuer with such actions through the clearing systems. In a post-default context, the trustee's role transforms to act as a fiduciary serving to preserve the bondholders' interests by declaring an event of default and taking such enforcement steps as the bondholders instruct.

Purchase Agreement

The purchase agreement is the contract between the Issuer and the underwriters (referred to as "initial purchasers" in the context of an unregistered offering), 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

For secured high-yield bonds, the intercreditor agreement governs the common terms and relationships among the secured creditors with respect to the shared collateral. The parties to the intercreditor agreement include the main secured creditors of the Issuer, including the lenders under the Issuer's secured credit facilities and the trustee for the secured bonds. The agreement contains provisions limiting the ability of creditors to vary their respective rights and addresses such issues as notifications of defaults, which parties are able to make decisions with respect to enforcement remedies on the shared collateral and the order of applying proceeds from the sale of shared 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, counsels for both the Issuer and the initial purchasers 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 (*see* discussion above)). As noted earlier during our discussion of the due diligence process, Rule 10b-5 letters indicate, in connection with such counsels' work with respect to the offering and as a result of their own investigations, nothing has come to their attention that has caused such counsels to believe 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 meets the standards established by the U.S. 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 and the Issuer's board of directors. In the comfort letter, the auditors (i) reaffirm their independence, (ii) state that, in their opinion, the financial statements of the Issuer audited by them and included in the offering memorandum comply as to form in all material respects with the applicable accounting requirements of the Securities Act and the related rules and regulations adopted by the SEC (or, for private issuers, in accordance with GAAP), (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 the original comfort letter is still valid.

Post-Launch

To market and build momentum for the offering, the Issuer and the initial purchasers typically conduct 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 physical 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. 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 two to five business days after the pricing date ("T+2" - "T+5"), the bonds are formally issued and delivered by the Issuer against payment therefore by the initial purchasers.

Global Comparison of High-Yield Bond Covenant Packages

There is a general global structure for high-yield bond covenant packages, which manages for the major risks of cash leakage, risky investments, increased leverage, subordination and corporate governance changes. However, the globally structured high-yield covenant package is slightly tailored in each of the three major high-yield bond markets: the United States, Europe and Asia. The following table summarizes the important differences of typical high-yield bond covenant packages globally.

<table>
<tr><th colspan="3">Guarantors</th></tr>
<tr><td colspan="2">Bondholder Protection</td><td>Strongest protection in the United States and Europe</td></tr>
<tr><td rowspan="3">DISTINGUISHING CHARACTERISTICS</td><td>UNITED STATES</td><td>Bonds are often guaranteed by all Restricted Subsidiaries, other than foreign subsidiaries (due largely to tax reasons) and immaterial subsidiaries.

Often, only Restricted Subsidiaries that guarantee other debt of the Issuer and/or incur debt are required to become guarantors.</td></tr>
<tr><td>EUROPE</td><td>As a starting position, comprehensive guarantor coverage (at least 80%+/as close as possible to 100% of EBITDA, revenue and assets) for “senior bonds” is common and desirable.

Guarantor coverage would ideally include all (material) domestic and foreign subsidiaries. In practice, however, corporate and insolvency laws of many European jurisdictions significantly limit the usefulness and enforceability of upstream guarantees, unless there is a clear, direct corporate benefit to the relevant subsidiary guarantor.</td></tr>
<tr><td>ASIA</td><td>Asian high-yield bonds issued by Issuers outside the PRC follow the U.S. or European guarantor models.

For high-yield bonds issued by PRC-based Issuers, bondholders outside of the PRC only receive subsidiary guarantees from non-PRC subsidiaries, which typically account for only a nominal proportion of the Issuer’s assets. As such, structural subordination is often a dominant characteristic of high-yield bonds involving Issuers with substantial assets or operations in the PRC.</td></tr>
</table>

Limitation on Indebtedness		
Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Fixed Charge Coverage Ratio (FCCR) is typically 2.0, but can range from 2.0 to 2.5. Typically, non-guarantor Restricted Subsidiaries are not permitted to incur Ratio Debt, thereby reducing structural subordination. “Credit Facility” in the Credit Facility basket is defined very broadly to include debt securities and other types of debt in addition to commercial bank credit facilities. Trend is for other dollar baskets, such as the Purchase Money Indebtedness basket and the General Indebtedness basket, to be capped at the greater of a fixed dollar amount or a growth component (*e.g.*, percentage of Total Assets). Issuers prefer to include the ability to later reclassify debt incurred under a basket as Ratio Debt if the FCCR could be met, thereby allowing the basket to be “refreshed.”
	EUROPE	FCCR is typically 2.0, but can range from 2.0 to 2.5. Typically, non-guarantor Restricted Subsidiaries are not permitted to incur Ratio Debt, thereby reducing structural subordination. Common to include additional “consolidated secured debt ratio” test (consolidated total debt/consolidated EBITDA) for incurrence of additional Ratio Debt secured by liens to get rating agencies and investors comfortable that Issuer will not increase its gearing excessively. Especially for cyclical businesses with currently high EBITDA, consolidated secured debt ratio (rather than FCCR) can become principal limitation on ability to incur additional Ratio Debt. “Credit Facility” in the Credit Facility basket is defined very broadly to include debt securities and other types of debt in addition to commercial bank credit facilities.

Limitation on Indebtedness		
Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS		Issuers prefer to include ability to later reclassify debt incurred under a basket as Ratio Debt if ratio test could be met, allowing the relevant baskets to be "refreshed."
	ASIA	FCCR is between 2.0 and 3.5.[11] For high-yield bonds issued by PRC-based Issuers, non-guarantor Restricted Subsidiaries are not allowed to incur debt under the FCCR. It is also common, under high-yield bonds issued by PRC-based Issuers, to limit the incurrence of debt by Restricted Subsidiaries to 10% to 15% of total assets, although this may exclude any debt issued in a public or private offering to institutional investors. Most high-yield bond offerings by PRC-based Issuers do not have a credit facility carve-out. With respect to Permitted Indebtedness, high-yield bonds issued by PRC-based Issuers limit the General Indebtedness basket (and other baskets) to a fixed dollar amount or percentage of total assets, although weaker bonds typically use the greater of a fixed dollar amount and a percentage of total assets, which can include certain intangible assets. High-yield bonds issued by Indonesia-based Issuers sometimes include the concept of permitted priority indebtedness, in which structurally senior debt can be incurred by non-guarantors if (i) structurally and contractually senior debt is less than 15% of total assets and (ii) the applicable ratio test is satisfied.

[11] Under high-yield bonds issued by PRC-based Issuers, the Fixed Charge Coverage Ratio typically is between 2.5 and 3.5. Under high-yield bonds issued by Indonesia-based issuers, the Fixed Charge Coverage Ratio typically is between 2.0 and 3.5.

Limitation on Restricted Payments		
Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Typical negotiated items: • In the context of calculating the Net Income Builder basket (or the Restricted Payments Builder basket), whether equity contributions and proceeds from equity issuances can be fair market value of non-cash consideration, or only cash. • Whether the equity that is issued to make an "equity claw" redemption of the bonds can also be counted toward the build-up of the General Restricted Payments basket. • Whether the "return on investments" component of the General Restricted Payments basket is calculated on each separate investment (whereby the basket cannot increase by more than the amount of the individual investment) or whether it is calculated on an aggregate basis among all investments (which is more Issuer-friendly). • Whether an Issuer can later reclassify a Restricted Payment made under a specific basket as a Restricted Payment made under the Net Income Builder basket once the Issuer is able to meet the FCCR condition. • Buyback of management stock subject to an annual cap with a rollover for unused amounts. • Dividends on Disqualified Stock incurred under the Limitation on Indebtedness covenant, as long as the dividends are included as fixed charges. • Whether unlimited Restricted Payments and Permitted Investments can be made subject only to leverage tests.

Limitation on Restricted Payments		
Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS		• Size of the General Restricted Payments basket, Joint Venture Permitted Investment basket and General Permitted Investment basket.
	EUROPE	Typical negotiated items: • In the context of calculating the Net Income Builder basket, whether equity contributions and offering proceeds can be the fair market value of non-cash consideration, or only cash. • Whether proceeds from equity offerings that are used to make an "equity claw" redemption of the bonds can also be counted toward the build-up of the Net Income Builder basket. • Size of General Restricted Payments basket, Joint Venture Permitted Investment basket and General Permitted Investment basket.
	ASIA	High-yield bonds issued by PRC-based Issuers often include the General Restricted Payments basket as a component of the Net Income Builder basket, rather than as a separate carve-out, which forces the Issuer to comply with the FCCR test in order to use the General Restricted Payments basket.

<table>
<tr><th colspan="3">Limitation on Liens</th></tr>
<tr><td colspan="2">Bondholder Protection</td><td>Strongest protection in Asia and weaker similar protection in the United States and Europe</td></tr>
<tr><td rowspan="3">DISTINGUISHING CHARACTERISTICS</td><td>UNITED STATES</td><td>Covenant generally triggered by liens securing debt, as opposed to the incurrence of liens for other purposes.

Attention should be given to whether all Permitted Indebtedness under “Credit Facilities” may be secured by a Permitted Lien (including Ratio Debt) or only debt under the specific Credit Facility basket.

Other negotiated points include (i) size of General Permitted Lien basket and (ii) whether there is a Secured Leverage Ratio Permitted Lien basket and, if so, the size of the ratio.</td></tr>
<tr><td>EUROPE</td><td>Covenant generally triggered by liens securing debt, as opposed to the incurrence of liens for other purposes.

Attention should be given to whether all permitted Ratio Debt and debt under “credit facilities” may be secured by a Permitted Lien or, if a secured deal, permitted collateral lien, or only debt under the specific Credit Facility basket.

Other negotiated points include (i) size of General Permitted Lien basket and (ii) whether there is a Secured Leverage Ratio Permitted Lien basket and, if so, the size of the ratio.</td></tr>
<tr><td>ASIA</td><td>Indebtedness permitted under the Limitation on Indebtedness covenant is typically permitted to be secured.

Many high-yield bonds issued by PRC-based Issuers do not have a Credit Facility basket and thus no corresponding lien basket. Secured bonds issued by PRC-based Issuers often allow permitted pari passu debt with no ratio test, which effectively allows for unlimited dilution of the collateral.</td></tr>
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<table>
<tr><th colspan="3">Limitation on Asset Sales</th></tr>
<tr><td colspan="2">Bondholder Protection</td><td>Strongest protection in Asia and weaker similar protection in the United States and Europe</td></tr>
<tr><td rowspan="2">DISTINGUISHING CHARACTERISTICS</td><td>UNITED STATES</td><td>Covenant has become progressively weaker in the current market. Negotiated items typically include:
Types of consideration that will count as cash toward the 75% cash consideration requirement.
Type of debt that can be repaid with asset sale proceeds (debt structurally senior to the bonds or any unsubordinated debt).
Transactions excluded from the definition of “Asset Sale,” including size of the dollar threshold exemption.
For permitted uses of proceeds from Asset Sales, does any capital expenditure count or does it have to be a purchase of assets?
Asset Sale proceeds generally need not be spent within 365 days (or other specified time period), as long as a binding contract is in place within such time period, and proceeds are, in fact, spent during a subsequent 180-day period.</td></tr>
<tr><td>EUROPE</td><td>Negotiated items typically include:
Types of consideration that will count as cash toward the 75% cash consideration requirement.
Type of debt that can be repaid with Asset Sale proceeds (debt structurally senior to the bonds or any unsubordinated debt).
Transactions excluded from the definition of “Asset Sale,” including size of the dollar threshold exemption.
Asset sale proceeds generally do not have to be spent within 365 days (or other specified time period), as long as a binding contract is in</td></tr>
</table>

Limitation on Asset Sales		
Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
		place within such time period, and the proceeds are, in fact, spent during a subsequent 180-day period.
	ASIA	Under high-yield bonds issued by PRC-based Issuers, the Asset Sale covenant often includes an additional requirement that the Issuer meet the Fixed Charge Coverage Ratio in connection with any sale of a Restricted Subsidiary, division or line of business. High-yield bonds issued by PRC-based Issuers often restrict Restricted Subsidiaries from entering into any sale-leasebacks. Some high-yield bonds issued by Indonesia-based Issuers also prevent Restricted Subsidiaries from entering into sale-leasebacks, but allow the parent to enter into sale-leasebacks in certain circumstances. Many high-yield bonds issued by Indonesia-based Issuers include an additional requirement that the Issuer be able to incur Ratio Debt for an asset disposition or sale of a Restricted Subsidiary, division or line of business.

Limitation on Transactions with Affiliates		
Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Trend not to require independent fairness opinions, relying instead on approval of independent directors. Broad exceptions to covenant, including permitted Restricted Payments and Permitted Investments.
	EUROPE	Negotiation items typically include appropriate threshold for fairness opinion. Broad exceptions to covenant, including permitted Restricted Payments (other than Permitted Investments).
	ASIA	Under high-yield bonds issued by Asia-based Issuers, the covenant is often extended to apply to 5% to 10% stockholders.

Limitation on Merger, Consolidation and Sale of Substantially All Assets

Bondholder Protection		Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Trend is to require that either the Issuer could incur $1.00 under the Fixed Charge Coverage Ratio on a *pro forma* basis, or the *pro forma* Fixed Charge Coverage Ratio is not worse or is better than prior to the transaction. Requirement for leverage ratio condition is becoming less common for stronger credits.
	EUROPE	Frequently negotiated item includes whether Issuer must be able to incur $1.00 under the Fixed Charge Coverage Ratio on a *pro forma* basis, or the *pro forma* Fixed Charge Coverage Ratio must be not worse or is better than prior to the transaction. Typical requirement that successor company be incorporated in "pre-expansion" (*i.e.*, pre-2003) EU country, Switzerland or United States (*i.e.*, assuming Issuer is not organized in post-expansion EU country).
	ASIA	In addition to the typical U.S. and European market requirements, high-yield bonds issued by PRC-based Issuers require that (i) the Issuer or the surviving entity have a consolidated net worth equal to or greater than the consolidated net worth of the Issuer prior to the transaction and (ii) no rating decline has occurred. Many high-yield bonds issued by Indonesia-based Issuers also require the Issuer or the surviving entity to have a consolidated net worth equal to or greater than the consolidated net worth of the Issuer prior to the transaction. Certain high-yield bonds issued by Indonesia- based Issuers also require the surviving entity to be incorporated in Indonesia, Singapore or the United States.

Change of Control		
Bondholder Protection		Strongest protection in the United States and weaker similar protection in Europe and Asia
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Portability with double trigger (*i.e.,* Change of Control *plus* ratings decline) is typical only in stronger credit issuances and sponsor deals. Portability less common than in non-U.S. jurisdictions.
	EUROPE	Portability with double trigger (*i.e.*, Change of Control *plus* ratings downgrade or leverage test) is typical only in stronger credit issuances and sponsor deals.
	ASIA	Under high-yield bonds issued by PRC-based Issuers, double triggers are common (with the requirement that the rating downgrade event occur within six months of the Change of Control event). High-yield bonds issued by Indonesia-based Issuers may have single or double triggers.

<table>
<tr><th colspan="3">Reporting Covenant</th></tr>
<tr><td colspan="2">Bondholder Protection</td><td>Strongest protection in the United States and weaker similar protection in Europe and Asia</td></tr>
<tr><td rowspan="2">DISTINGUISHING CHARACTERISTICS</td><td>UNITED STATES</td><td>Pubic Issuers are required to furnish all quarterly, annual or certain reports that would be required on Forms 10-Q, 10-K and 8-K, respectively. Private Issuers are required to furnish annual and quarterly reports containing information consistent with the offering memorandum and certain reports that would be required under Form 8-K.

Trend to give extended cure periods to reporting defaults, sometimes with an increase in interest rate.

Another trend is for the Issuer to agree to hold quarterly conference calls with investors to discuss financial results.

Certain privately-held (e.g., family-owned) Issuers only make reports available on password-protected investor relations website. This may become an issue in 2025, under Rule 15c2-11.</td></tr>
<tr><td>EUROPE</td><td>The Issuer is required to deliver annual reports 120 days after year-end, quarterly reports 60 days after each of the first three fiscal quarters, and descriptions of certain material events promptly after they occur. First-time Issuers typically have 90 days for the first quarterly report.

Frequently negotiated and increasing focus of investors is access to and required quality/scope of reports, in particular whether reports must be substantially similar in scope and content to (Rule 144A) offering memorandum or if lower standard applies.

Certain privately-held (e.g., family-owned) Issuers only make reports available on password-protected investor relations website.</td></tr>
</table>

Reporting Covenant		
Bondholder Protection		Strongest protection in the United States and weaker similar protection in Europe and Asia
	ASIA	High-yield bonds by Asia-based Issuers typically adopt the European requirements, although there is some case-by-case variation.

Fall-Away Covenants		
Bondholder Protection		Equal protection in the United States, Europe and Asia
DISTINGUISHING CHARACTERISTICS	UNITED STATES	"Suspension" more typical than permanent "fall-away." The Change of Control and Limitation on Liens covenants are not fall-away covenants, as neither a Change of Control nor the creation of a lien for the benefit of other creditors can be later undone. Also, the Limitation on Lien covenant is a standard covenant in an investment-grade covenant package.
	EUROPE	"Suspension" more typical than permanent "fall-away." The Change of Control and Limitation on Liens covenants are not fall-away covenants for the same reason as in the United States.
	ASIA	"Suspension" more typical than permanent "fall-away." The Change of Control and Limitation on Liens covenants are not fall-away covenants for the same reasons as in the United States.

Additional Resources

Free Writings & Perspectives

Our blog, Free Writings & Perspectives, provides up-to-the-minute news regarding securities law developments, particularly related to capital formation, as well as commentary regarding developments affecting private placements, late-stage private placements, PIPEs, IPOs and the IPO market, and new financial products. **Visit** http://www.freewritings.law.

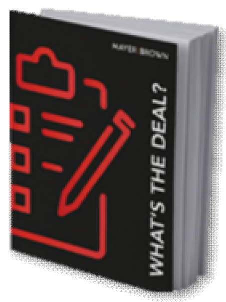
Corporate Finance and the Securities Laws

Corporate Finance and the Securities Laws is the “go-to” resource which explains the mechanics of corporate finance together with statutes that govern each type of deal. The updated Sixth Edition, co-authored by Mayer Brown partner Anna Pinedo, covers a wide range of financing techniques – from IPOs to private placements and other exempt offerings, shelf-registered offerings, offshore offerings, stock buybacks, tender and exchange offers, debt restructurings, spin offs, convertible securities, asset backed securities and insurance linked securities. It also addresses liability issues and due diligence, anti-manipulation rules and capital markets-related FINRA rules. **Visit** https://bit.ly/3NnH62d.

Structuring Liability Management Transactions

Structuring Liability Management Transactions, published by the International Financial Law Review, provides a summary of the U.S. legal framework, including guidance provided in numerous no-action letters issued over many years, applicable to debt repurchases, tender offers and exchange offers. Mayer Brown authors also present some of the main regulatory and tax considerations that should be taken into account when determining the best approach. **Visit** https://bit.ly/3me9qre.

What's the Deal?



Our *What's the Deal?* compendium includes brief discussions in plain English of popular financing methodologies, securities law issues, and practice pointers. With over 170 pages of content, the compendium is available online to print. Contact your Mayer Brown lawyer for a physical copy, or access the compendium here: https://bit.ly/3xudqdE.

Writing on the Wall

Writing on the Wall offers explanations and definitions for over 900 securities, capital markets, derivatives, structured finance and financial services terms and phrases. **Access the illustrated glossary at** www.writingonthewall.com.

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