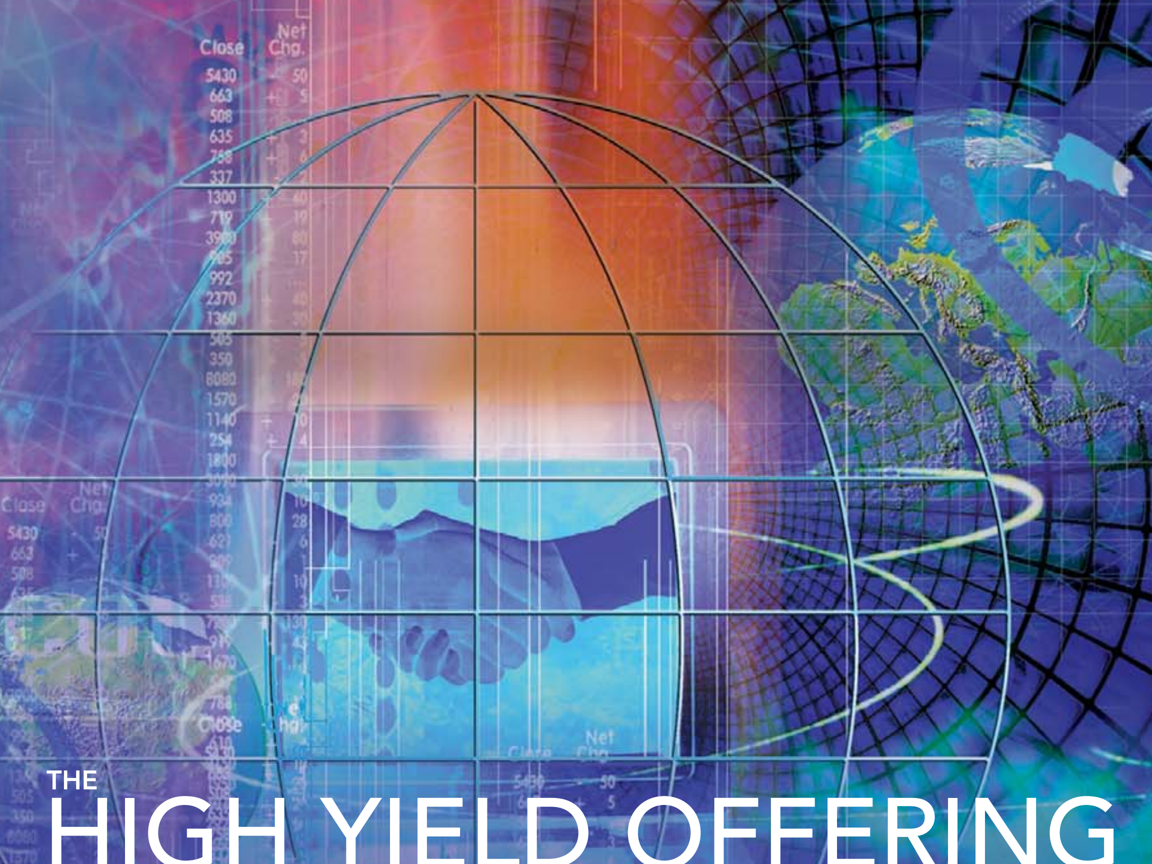

THE HIGH YIELD OFFERING

An Issuer's Perspective

Mark B. Tresnowski and Gerald T. Nowak

Kirkland & Ellis LLP

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INTRODUCTION

High yield debt is an integral part of the capital structure of many companies. Its principal benefit to the issuer is to provide long-term debt financing to issuers of less than investment grade credit quality without the financial covenants and many of the other restrictions typically found in traditional credit facilities. Its principal benefit to investors, as the name would imply, is a high interest rate, or yield, as well as the possibility of capital appreciation as the credit quality of the issuer improves over time. Because of these mutual benefits to issuers and investors, high yield notes have become an important fixture in the array of securities available for purchase and sale in the capital markets.

The high yield debt, or "junk bond," industry has a colorful and checkered past. In the early to mid-1970s "high yield bonds" were those issued by companies, known as "fallen angels," that fell below investment grade rating after the bonds were initially issued. A more broad-based high yield debt market subsequently emerged when companies and their underwriters began to issue below-investment-grade debt in initial offerings. In the 1980s, an increased wave of takeovers and leveraged buy-out transactions further fueled the growth of high yield debt as a financing mechanism. By 1991, however, two well-publicized

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events brought the high yield debt industry into the spotlight. The first was the cause célèbre of the "junk bond king," Michael Milken, and his alleged insider trading and stock manipulation schemes. Milken, along with the equally notorious Ivan Boesky, became enduring symbols of the freewheeling "greed is good" 1980s. The second event was the collapse of the savings and loan industry, which many blamed on the risky junk bond portfolios that savings and loan institutions held. Though these scandals were not a direct indictment of the economic value of high yield debt in the capital markets, popular culture has since associated junk bonds with these infamous events.

Since the early 1990s, the high yield market has undergone rapid expansion, made possible in large part by regulatory changes discussed later in this book. A Thomson Financial Securities Data study reported that the total value of high yield debt offerings in 2003 was approximately $123.2 billion. This contrasts with a 1991 Donaldson, Lufkin & Jenrette study where the combined value of high yield debt and preferred stock offerings that year totaled only $12.3 billion.

The term *high yield offering* describes an offering done under a variety of circumstances, with the common denominator being the issuance of debt under an indenture by an issuer of less than investment grade quality. These offerings can be, and often are, done:

- by established public companies that, for one reason or another, do not carry an investment grade rating;
- by private companies that are looking to reorganize their capital structure; and
- to provide financing for a leveraged buy-out.

High yield offerings can be, but are typically not, registered in the first instance with the SEC. The more common approach is to do a private placement pursuant to an offering memorandum followed by a registered "A/B exchange offer" under which the initially issued unregistered notes are exchanged for registered notes. One consistent theme that is critical to understanding such an offering is that, while the initial private placement is not subject to SEC registration and related disclosure and liability rules *per se*, the market practice is to treat the offering as if it were. Many activities associated with this form of offering can only be understood by acknowledging that market practice.

If you are reading this book, chances are that your company is considering issuing a series of high yield notes. This book is designed to clear away some of the mystery surrounding the terms of the notes and the offering process itself. High yield notes are complex instruments, and professionals in the field sometimes assume too much knowledge on the part of the CFOs and other corporate executives with whom they work. "Inside baseball" type jargon runs rampant, with terms like *ratio debt* and *A/B exchange* thrown around as if they were self-explanatory. The primary audience for this book is the CFO, who needs to understand the terms of the notes and the mechanics of the offering process, not from the lofty "30,000-foot level" where the CEO's perch lies, nor from the "weeds" where we lawyers dwell, but rather from the sensible "15,000-foot level" where key financial and structuring decisions are often made. We hope that by approaching the subject at that level, this book may be of maximum use not only to the CFO, but also to those advising the CFO, by helping to clarify a number of issues that, by their nature, often seem too complex to describe in everyday terms.

A high yield offering can generally be divided into three parts:

- Preparing the offering memorandum;
- Negotiating the terms of notes; and
- Effecting the post-transaction registration of the notes.

This book is generally organized to follow the chronological sequence of events that take place in a high yield offering.

Chapter I: Gearing up for the Offering discusses certain threshold requirements for accomplishing a high yield offering, as well as some practical steps the company can take to make the process go more smoothly once it begins. It also describes the various team members and their institutional roles in the process.

Chapter II: Managing the Process discusses the process itself and gives some helpful tips on how to make the process run more smoothly.

Chapter III: The Offering Memorandum describes the principal sections of the offering memorandum and their basis in the SEC rules and regulations.

Chapter IV: The Credit Parties describes the various ways that the members of the issuer's corporate family can be treated under the indenture, and why.

Chapter V: The Covenant Package describes the principal covenants included in a high yield indenture.

Chapter VI: The A/B Exchange describes the process by which the notes will be registered with the SEC after the initial private placement has been completed.

Chapter VII: Living with the High Yield Indenture describes a number of additional issues associated with living with the high yield indenture once the notes have been issued.

Chapter VIII: The Sarbanes-Oxley Act describes the implications of the Sarbanes-Oxley Act of 2002 upon the obligations of an issuer of high yield notes.

Chapter IX: Rule 144A describes the exemption from registration under the Securities Act provided by Rule 144A.

We have also included the following appendices that may be of use if you want to dig a little deeper:

Appendix A:	Annotated high yield indenture covenants.
Appendix B:	Sample timeline for high yield offering.
Appendix C:	Significant provisions of Sarbanes-Oxley Act applicable to high yield issuers.
Appendix D:	Sample prospectus section describing exchange offer mechanics.
Appendix E:	Sample D&O questionnaire.
Appendix F:	Sample Exxon Capital letter to SEC.

CHAPTER I
GEARING UP FOR THE OFFERING

A. PREPARING THE COMPANY

A high yield offering is a time-consuming process, lasting anywhere from six weeks to three months, not including the A/B exchange offer. It behooves all involved to approach it in the most efficient and organized manner possible. Moreover, an unregistered high yield offering is often the selected financing strategy precisely because it can be done quicker than a financing that is initially registered and potentially reviewed by the SEC. For this reason, imposing efficiency and organization on the process is particularly important in light of the parties' expectation that they are pursuing the quickest path to the capital markets.

A principal feature of a high yield offering is the offering memorandum. As described in more detail in Chapter III, the practice is to draft the offering memorandum as if it were a prospectus for an offering registered with the SEC, including the required financial statements. With that in mind, the following are a few steps that can be taken by the company, with or without the benefit of outside advisors, to prepare itself for the offering process.

1. FINANCIAL STATEMENTS

One of the most time-consuming aspects of preparing an offering memorandum is the preparation of SEC qualified financial statements. For an existing public company, these will have already been prepared in the ordinary course of business and can be incorporated by reference to the company's periodic reports filed with the SEC. Also, most private companies that are mature enough to undertake a high yield offering have a history of engaging an independent public accountant to audit their financial performance. Nonetheless, for a company that has not published audited financial statements in the past, the preparation of such financial statements can be extremely time-consuming and should be undertaken as soon as a decision is made to pursue a high yield offering.

Financial statements, more so than other information about the company, rapidly become stale. The requirements for the timeliness of financial statements are set forth in Articles 3-01, 3-02 and 3-12 of Regulation S-X. As a general matter, an offering memorandum must have three years of audited financial statements, an additional two years of selected financial data, which need not be audited, and, if applicable, interim period financial data for the period ended no more than 135 days (or sooner for accelerated filers) from the date the offering memorandum is published. Of course, the technical requirements for the financial statements themselves are contained in the accounting literature and, by way of gross understatement, are voluminous.

One particular accounting requirement that applies to high yield offerings is contained in Article 3-10 of Regulation S-X, and relates to financial statements for guarantors. In short, separate financial statements are required for each guarantor *unless* such guarantor is wholly owned by the issuer (or, in the case of a parent guarantor, the issuer is wholly owned by the parent and it is the parent's financial statements being presented), the guarantee is full and unconditional and all guarantees are joint and several. If all of those conditions are met, separate financial statements need not be prepared. However, the issuer's financial statements must contain a footnote showing condensed consolidating financial information for the issuer, the parent company (if applicable), all guarantor subsidiaries as a group and all other subsidiaries as a group, as well as consolidating adjustments and total consolidated amounts. Potential issuers should not underestimate the time it can take to prepare this footnote. Companies that report on a consolidated basis often do not distinguish among their subsidiaries in any material way, and preparing what amounts to a condensed set of separate financial statements distinguished in that manner can take weeks.

Because the guarantees of a security are themselves deemed to be securities for SEC reporting purposes, the question often arises as to whether the guarantors are required to file separate '34 Act reports. Rule 12h-5 under the '34 Act grants relief from '34 Act reporting for guarantors who meet the requirements for separate financial statement relief under Article 3-10 described above.

Another accounting requirement that applies to high yield offerings as well as traditional registered offerings is the requirement to present separate financial statements for a target company if its acquisition has occurred or is "probable." There is no clear guidance on when an acquisition is probable. Most practitioners would tell you that an acquisition is probable if a definitive agreement or binding letter of intent has been signed *and* approved by the boards of directors of both companies. Short of that, it is a judgment call.

The financial statements required for an acquisition will depend on the "significance" of the acquisition target. The significance of the acquisition target depends of the following conditions:

- The company's equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle of the target as a percentage of such income of the company on a consolidated basis for the most recently completed fiscal year.
- The company's proportionate share of the total assets of the target as a percentage of the company's total consolidated assets as of the end of the most recently completed fiscal year.
- The company's investment in the target as a percentage of the company's total consolidated assets as of the end of the most recently completed fiscal year.

If none of the conditions exceeds 20%, financial statements for the target company are not required. If any of the conditions exceed 20%, but none exceeds 40%, financial statements are required for the most recent completed fiscal year and any applicable interim periods. If any of the conditions exceed 40%, but none exceeds 50%, financial statements are required for the two most recent fiscal years and any applicable interim periods. Finally, if any of the conditions exceed 50%, financial statements are required for the three most recent fiscal years and any applicable interim periods. Notwithstanding the foregoing, if the aggregate impact of individually insignificant acquisitions since the end of the most recent fiscal year exceeds 50%, financial statements covering at least the substantial majority of the acquisitions for three fiscal years and any interim period are required.

The question of whether an acquisition is "significant" or "probable" is also relevant to the need for pro forma financial statements, as discussed in Chapter III, Section C.

One final, but often overlooked, financial statements requirement applies to offerings of *secured* high yield bonds. Under Article 3-16 of Regulation S-X, if the assets of a guarantor subsidiary account for 20% or more of the size of the *secured offering* (not the company), separate financial statements of that guarantor are required. Note that while secured high yield offerings are still not the norm, they have become less rare in recent years.

2. Company Description

One of the most time-consuming aspects of executing a high yield offering is the preparation of the offering memorandum. Even for a public company, this can take quite a bit of time, as the investment bankers will invariably want to modify and often expand the company's existing public disclosure to help in their marketing efforts. For public companies, however, there will be a sensitivity to changing their public disclosure, as it can call into question the accuracy or completeness of the original disclosure at the time it was issued.

For private companies, the challenge is to craft an accurate, complete and "sexy" description of the business in a timely and efficient manner. The efficiency of the process can be enhanced by collecting any documents that contain descriptions of the company or its products and services and forwarding them to company counsel early in the process. The best source document is often an information memorandum prepared in connection with the sale of the business, for an acquisition financing deal or in connection with the syndication of a senior credit facility. Also useful are marketing materials or consultant's reports.

Company management may be tempted to put pen to paper and craft a business description prior to assembling the working group. This is not for the faint of heart. Whatever initial draft is presented to the working group will be torn to shreds, regardless of the professionalism or knowledge of the author. Part of this is just the nature of drafting by committee, but most of it arises out of the healthy interplay between those who want to successfully market the offering and those who understand and have witnessed first hand the way plaintiffs in a securities lawsuit will scrutinize and try to capitalize on any alleged misstatements or omissions in the disclosure document. Experienced company counsel will be accustomed to this dynamic and can help the company's executives understand and separate the useful and necessary gives and takes of the drafting process from the useless and unnecessary bickering over language that often arises. Language drafted by company executives, however, can pose a psychological challenge throughout the working group sessions, with some members reluctant to challenge it for client relationship reasons, and some members of management reluctant to change it absent manifest error, for their own personal or professional reasons. In general, for all members of the working group, pride of authorship is an emotion best saved for the finished product.

3. DUE DILIGENCE

Collecting due diligence materials is among the best uses of the company's time in preparing in advance for a high yield offering. The investment bank's counsel (as well as issuer's counsel) will invariably want to see a comprehensive set of due diligence documents. Once the drafting process gets under way in earnest, the company's time is usually better spent focusing on the draft, rather than on due diligence. Issuer's counsel can provide the company with a sample due diligence checklist to aid in the collection of due diligence materials. The investment bank's counsel should be willing to review the materials organized according to that checklist and supplementally request any materials they feel might be missing. Virtual data rooms that organize and make available all relevant documents over a secure Internet connection can be extremely useful in minimizing the imposition on the company of the due diligence process, in making the due diligence process as efficient as possible and in establishing a clear record for everyone's benefit.

It is worth noting that, as described in the introduction, most high yield offerings are done at least initially via a private placement. This calls into question the role of due diligence in such an offering. In a registered offering, due diligence plays two clearly defined roles: first, to gain an understanding of the company with a view toward minimizing the possibility of errors or omissions in the prospectus, and second, to establish the underwriters', officers' and directors' due diligence defenses under Sections 11 and 12(a)(2) of the '33 Act. The due diligence defense, remarkably enough, allows a potential defendant to avoid liability simply by proving that he, she or it "tried" hard enough to verify the data, even if the data turned out to be wrong or incomplete; but no such defense is available to the issuer under Section 11. Because the initial private placement is not a registered or public offering, however, courts have ruled that neither Section 11 nor 12(a)(2) liabilities apply under those circumstances. Nonetheless, in keeping with market practice and given the need to fulfill the first objective of complete and accurate disclosure, the participants act as though such liability would apply, and due diligence for a privately placed high yield offering is virtually indistinguishable from that conducted for a registered offering.

It is important not to give in to the temptation to relegate due diligence to a low point on the priority list. In addition to the legal liability defenses that can be established through the process, the due diligence effort also has a direct impact on the drafting of the offering document. Few things are more disheartening in an offering than the need to redraft large sections of the document only because due diligence brought new facts to light late in the game. The investment banks will also be using the results of the due diligence investigation as a basis for their presentation to their internal commitment committees, and no transaction will go forward unless these presentations are complete and responsive to any concerns that these committees may raise.

B. ASSEMBLING THE TEAM

Nothing is more critical to ensuring the success of a high yield offering than assembling the right team, both in terms of company management and external advisors. The quality of the work product and the success of the offering are, of course, dependent on it. In addition, the offering process itself is long and extremely intense. Realize that you will be spending a great deal of time with your teammates — you should select advisors with whom you believe you would be comfortable working, while at the same time realizing that a good “personality fit” should not override the need to get the most experienced and highest quality advisors.

1. Company Management

Appropriate participation by company management is key to the success of a high yield offering. It is imperative to balance the demands of running the business with the demands of the offering process. Company management must understand that its professionals can only do an offering *with* the company, not *for* the company. Many aspects of the offering process, from the road show to verifying the accuracy of the offering memorandum, can only be done by company management. That said, management will have hired a set of professionals that are expert in these matters, and it is entirely appropriate to rely on them for as much of the work as possible. At the end of the day, running the business is management's most important task.

Selecting the appropriate company personnel to work on the offering is one of the key decisions company management will make in the offering process. For smaller companies, the CFO, and often the CEO, will typically take a leading role. For larger companies, the treasurer and/or controller will often lead the charge. In either case, the company's law and accounting departments will also play a key role. It is critical that the persons charged with the responsibility for leading the offering also have the authority to make decisions in real time and have the knowledge base to answer factual questions about the company and its financial results and position. Whoever is charged with leading the process will find it to be extremely time-consuming and should allocate their time accordingly.

Aside from the company personnel leading the company team, other key executives will have to play some role as well. The working group, for due diligence and other reasons, will often want to hear directly from sales, marketing, operations and business planning and development personnel and, if appropriate, technical and regulatory personnel. To minimize disruption to the business, at some point in the process, usually after one or two drafting sessions, it may make sense to schedule a day-long meeting at the company's headquarters during which the senior executives in each relevant function make a presentation to the working group, followed by a question and answer session. In these meetings it is entirely appropriate for the company's senior executives to participate, but care should be given to allowing the various management team members to speak freely and openly about their business units. Few things raise concerns among the working group like limiting access to, filtering or spinning the views of the issuer's second or third tier of executives.

2. Investment Bankers

Next to company management, the investment bankers will play the most important role in the offering process. From advising the company about the market dynamics, to crafting the offering memorandum, to execution of the offering, the bankers will take a leading role throughout.

One nomenclature issue that can cause confusion in a typical high yield offering is what the investment bankers are called. Of course, in a registered underwritten public offering, the investment bankers are called "underwriters." But because that is a loaded term for Securities Act liability purposes, the practice is to call the investment bankers in an unregistered high yield offering "initial purchasers." This somewhat awkward phrase refers to the fact that, as described in Chapter VI, the investment banks actually *initially purchase* the notes from the issuer and then on-sell them to their accounts (who the uninitiated would, incorrectly, think of as the "initial purchasers"). To help the reader get used to this nomenclature, we will refer to the investment bankers as "initial purchasers" throughout the rest of this book.

When selecting the initial purchasers, key considerations include their track record, their industry experience, their reputation and their other business relationships with the company, *i.e.*, their participation in the company's senior credit facility or other relationship issues. Although it is has become a lightning rod for controversy in recent years, the research analyst strength of a firm in the company's industry remains a key consideration. If your offering is being taken to market by a firm that employs a well-known and respected industry analyst for your business, that can significantly enhance the success of the transaction and help position the company well thereafter.

The initial purchasers' style in managing the process can make a tremendous difference in the efficiency of the process and the demands on management. Some initial purchasers will instruct the company and its counsel to draft the offering memorandum, offering only conceptual advice after the fact and leaving the company and its counsel to try it again and again until it satisfies the initial purchasers' marketing needs. Others take an aggressively controlling approach, insisting on the final decision over every word on every page. Obviously, the ideal falls somewhere between the two, with the initial purchasers offering concrete ideas about how the offering memorandum should read, while respecting the views of other members of the working group regarding the final outcome. Company management can help steer the initial purchasers toward that ideal if any pathology develops in the working group dynamics.

3. Company Counsel

Hiring experienced company counsel is also key to the success of the high yield offering. Company counsel has primary responsibility for initially drafting the offering memorandum and redrafting after each drafting session. The quality of company counsel's work product will have a major impact on the efficiency of the drafting sessions. Nonetheless, management should understand that no matter how fine a work product is produced, each drafting session will result in hundreds of changes, as personal preferences differ, nuances are discovered and additional facts come to light.

Company counsel will also take a leading role in negotiating the indenture and other transaction documents on behalf of the company. As described in more detail in Chapter V, the negotiation of a high yield indenture is more art than science, and requires in-depth understanding not only of how a high yield indenture works, but also of the current state of the market for various terms and conditions contained in the indenture and a thorough appreciation of the company's current business and future plans. Initial purchasers and their counsel will invariably resort to the argument that "the market" will not accept a particular indenture provision. When faced with that comment, there is no substitute for depth of experience of the company's legal counsel in offering resistance.

Unlike the initial purchasers, whose success or failure will be evident in the transaction itself, company counsel has a much greater focus on the longer-term implications of the work product produced in the transaction. The offering memorandum and subsequent registration statement, for example, will come under intense scrutiny if the offered securities do not perform well in the market. Only then will a company appreciate whether its counsel did a good job. Similarly, the company will usually have to live with the indenture for years after the offering and often times the foresight and experience of company counsel will not become apparent until the company tries to run its business under the confines of the indenture.

Working group members may also not share company counsel's seemingly obsessive focus on various default scenarios and on how things might play out in a bankruptcy. It the lawyer's job, however, to focus on these downside scenarios even in the otherwise upbeat process of successfully raising money to fund a company's growth. You can rest assured that if these scenarios ever do occur, the company's alternatives can in large part be dictated by how well its counsel did in negotiating the indenture and structuring the transaction. The first thing creditors at all levels will do when a company falters is have their own lawyers scrutinize the indentures and other credit documents to look for chinks in the armor.

4. INITIAL PURCHASERS' COUNSEL

The role of initial purchasers' counsel in the offering is to lead the legal due diligence effort, participate in all drafting sessions and negotiate the high yield indenture and other transaction documents on behalf of the initial purchasers. Management will often question the extensiveness of the due diligence requests the initial purchasers' counsel will make. The requests tend to be standard, and the company has little choice but to comply. Experienced company counsel can advise the company as to whether the requests are reasonable and typical under the circumstances.

Initial purchasers' counsel is, obviously, hired by the initial purchasers; however, company management can choose to exert influence in their selection. Some frequent issuers will exhibit a preference for a firm that has previously represented other investment banks in connection with such issuer's public or private offerings, with a view toward reducing the due diligence burden. The initial purchasers will typically take that preference into account as the efficiencies involved will also inure to their benefit.

5. AUDITORS

The company's auditors obviously play a key role with respect to the audited financial statements, as well as the other financial portions of the offering memorandum, including the summary financial data, the selected financial data, capitalization, management's discussion and analysis and pro forma financial statements, if any. The auditors should also weigh in on the accounting-related definitions in the indenture, as they will approach those definitions from a different perspective than the lawyers and may have valuable insights. The auditors' input on this issue is also important because they will inquire about ongoing compliance with the indenture as part of their annual audit process.

The accounting team is generally the same as that devoted to the company's annual audit, but virtually all major accounting firms can call on specialists who can assist with issues that may arise in the context of an offering and, if necessary, an SEC review of the financial disclosures in the registration statement. As with initial purchasers and legal counsel, "brand name" accounting firms lend credibility to the offering and any savings realized by using lesser known firms may be more than offset by the reliability associated with the better known firms.

6. Trustee

The trustee is an important, if inconspicuous, player in the high yield offering process. The trustee should be selected for its experience, relationship with the company and willingness to support the process. Company counsel can often suggest a suitable trustee if the company does not otherwise have a view on its selection.

7. Financial Printer

The financial printer plays another important role in the offering process. The working group will spend a fair amount of time at the printer and the printer's responsiveness will have consequences for the efficiency with which the working group can complete its task. Note that the quality of the printer's work product will have unseen effects on the bills ultimately presented by the company's other professionals. At any given time, the company may have three or more lawyers and an equal number of accountants — all of whom bill by the hour at rates that are not trivial — sitting at the printer waiting for pages to turn. Thus, the printer's efficiency can have a significant impact on the company's legal and accounting expenses.

C. EXPENSES

Bringing together all of these professionals raises the not inconsequential issue of who is going to pay for them and how much will it cost. To the chagrin of many a CFO, the answer is that the company will pick up the tab and, while it will be a small percent of the money raised, it will not be inexpensive. Generally, the best way to manage the cost of an offering is to assemble the best, most experienced team available. This factor, more than billing rates or even the number of people working on the transaction, in our experience saves the company money by assuring that the process itself is efficient. For example, if counsel to the issuer and counsel to the initial purchasers are experienced in high yield offerings, they will virtually be able to complete each other's sentences (and, more importantly in the case of company counsel, respond with an appropriate and persuasive retort). They know the issues and know how they usually get resolved. If one or the other is new to the process, however, even lower billing rates will not make up for the countless hours it will take to "reinvent the wheel" on every issue. Education is an achievement best earned on someone else's nickel.

More specifically, it is customary for the issuer to pay for its counsel, the accountants, the printing expenses, all filing fees with state and federal agencies, ratings agency fees and some or all of the road show expenses. It is customary for the initial purchasers to pay for their counsel and their portion of the road show expenses. This customary allocation remains true both of offerings that are successfully completed and offerings that terminate before pricing. It is a historical quirk of the market (also true of underwritten public offerings) that if a transaction terminates after pricing and before closing, the company pays for the initial purchasers' expenses, including counsel. This is an extremely rare occurrence for many reasons, and the company can take cold comfort in the regrettable fact that, in such a circumstance, paying those expenses will be the very least of its problems.

CHAPTER II
MANAGING THE PROCESS

A. THE ORGANIZATIONAL MEETING

The high yield offering process begins in earnest with the organizational meeting. At this meeting, all members of the working group will meet each other and set the schedule for completing the process. The proposed schedule will typically be somewhere between aggressive and unachievable. Just how aggressive will depend on the company's need for capital and the initial purchasers' view of the market. Company executives should realize that the initial timetable often represents the best possible outcome and none of the professionals will want to be the first to question its achievability. As such, the practice is to start with an aggressive but not impossible timetable, push everyone to meet it, but know that adjustments often must and should be made. Rushing the process may seem like the best thing to do — and may at times be necessary — but the cost of doing so can be significant and may not be evident until problems arise well past the closing of the transaction.

One critical timing issue typically discussed at the organizational meeting is the availability of current financial statements. Financial statements go "stale" under applicable SEC rules 135 days (or sooner for accelerated filers) after the date of the latest balance sheet presented. The company and its auditors must be prepared to update any financial statements before they go stale. A related financial statement timing issue is the need to avoid pricing the offering after a quarterly accounting period has ended but prior to the finalization of the numbers for that period. Everyone, including the potential investors, will be nervous about closing the deal only to find out a week or so later that the company had a disappointing quarter.

B. DRAFTING THE OFFERING MEMORANDUM

Once the organizational meeting has taken place, the working group gets down to the business of drafting the offering memorandum.

Company counsel will prepare the initial draft, hopefully with input from the company in the form of any documents previously written about the company, including other private placement or information memoranda, bank books, consultant's reports or marketing materials. Company counsel is also aided immeasurably by the initial purchasers' provision of applicable precedent, both within the industry for "comparable" companies, and other offering memoranda prepared by the particular initial purchasers involved. Often, over the course of the offering, the initial purchasers will show a marked preference for presenting data the way they did in a particular deal. Identifying that deal early in the process will allow company counsel to get one step ahead, thereby increasing the efficiency of the process.

The working group will then settle in for a number of drafting sessions. There are basically two ways to approach the process. The traditional model is to have full-day, all hands drafting sessions once a week, with the intervening time split more or less evenly between company counsel redrafting based on the meeting and the rest of the working group reviewing the revised document. Thus, for a drafting session on a Thursday, company counsel would redraft Friday and over the weekend, and distribute the draft on Monday. The working group would then review the draft on Tuesday and Wednesday and reassemble the following Thursday. Note that trying to expedite this process will inevitably result in shortchanging either company counsel's redrafting time, diluting the quality of their work product, or the working group's review time, resulting in comments that are not fully thought through. In either case, the efficiency of the process actually suffers. One organizational tool that the authors have found helpful is to identify one day of the week for scheduling all drafting sessions. That way, all working group members can schedule around that day of the week for the rest of the process. Otherwise, at each drafting session the working group will discuss scheduling the next drafting session and one or more key players will inevitably have a schedule conflict.

Another, nontraditional, approach to the drafting process that the authors have found useful is to schedule multiple "mini" drafting sessions by phone over the course of the week. Each session focuses on one section of the offering memorandum and lasts from two to three hours. The benefits of this approach are to reduce travel time and expense, maintain the working group's focus and attention and balance the attention given to certain sections of the book that may be lost under the weight of the all-day drafting session. The downside is that, due to their frequency, these sessions must occur by phone and therefore lose some of the intimacy of the physical meeting. Our experience is that the offering process offers plenty of opportunity for intimacy; missing the chance to spend twelve hours locked in a conference room with twenty of your new closest friends is seldom met with regret.

Under either approach, the drafting process will typically take from four to six weeks. For issuers that are not currently SEC reporting companies, finishing the offering memorandum in less time than that is possible, but rare.

C. DUE DILIGENCE

The due diligence process consists of three parts: business due diligence, legal due diligence and financial due diligence. Business due diligence is typically accomplished with one or more site visits and management presentations regarding the company's business, prospects and strategy. Note that this often includes a Powerpoint presentation prepared by management. Issuers should be careful that the finished offering memorandum be consistent with that presentation or be prepared to defend the inconsistencies. It is fair to say that the business due diligence process in effect continues throughout the drafting sessions and for this reason it may be necessary to bring in management to follow up on issues covered at the initial presentation and in need of elaboration in order for the disclosure document to be accurate and complete.

Legal due diligence consists of document review by initial purchasers' and company counsel. Initial purchasers' counsel will prepare a document request list that will seem unduly burdensome and broad, but upon realizing that counsel is typically not asking the company to produce anything that does not exist, management will often find the list less objectionable. This is one aspect of the process that can be streamlined by advance preparation and by using a virtual Internet-based data room.

Financial due diligence will consist of the preparation and review of historical financial data, projections and business plans. The initial purchasers will often ask that the information be prepared and presented in a dizzying array of formats, all with a view toward better understanding, and therefore better ability to sell, the company and its ability to service the high yield notes. Financial due diligence goes to the heart of many of the issues and concerns associated with any offering of securities and it is far more common for liability claims to be based on inaccurate or incomplete financial information than on other disclosures. As such, it is a mistake to exclude the lawyers from this process. Good and experienced securities lawyers will be facile with the financial and accounting issues and can often help identify and resolve problems.

D. NEGOTIATING THE INDENTURE

Negotiating a high yield indenture is unlike any other negotiation with which the company is likely to have been involved. For starters, the practice is not to negotiate the indenture itself; rather it is to negotiate the section of the offering memorandum entitled "description of notes." That section will set forth, verbatim, the relevant covenants of the indenture, with the remainder of the indenture consisting of so-called "boilerplate." The exact terms of the notes as set forth in the indenture are too precise and important to risk summarizing or paraphrasing them in the disclosure document so, while it may seem odd to essentially duplicate this extensive language in the offering document, it is virtually mandatory market practice to do so.

The more substantive difference in these negotiations is that the roles and incentives of the various parties are less than clear cut. The company, for example, clearly wants maximum flexibility, but at the same time wants the notes to be marketable, and knows that marketability will suffer if the note terms differ materially from investor expectations. The initial purchasers' primary interest seems to be in keeping the indenture within the range of marketability, but at the same time they are the company's financial advisors and should be looking out for the company's financial interests. Adding to the complexity is the initial purchasers' interest in "franchise issues," *i.e.*, maintaining their credibility with buy-side players. Company and initial purchasers' counsel each approach the negotiation understanding their respective clients' interests.

That all said, the negotiation itself resembles a typical credit negotiation in which initial purchasers' counsel will present a description of notes that contains some, but not all, of the typical carveouts that a company can expect to receive. Company counsel will then work with the company to prepare a mark-up that addresses the company's needs and brings the description of notes up to what, in company counsel's experience, is a "market" deal. The parties will then negotiate from a posture that basically has the company and its counsel asking for additional flexibility and the initial purchasers' and their counsel resisting those requests. Only at the very end of the negotiation will each party recognize the subtext of their respective interests, *i.e.*, marketability on the part of the company, and their role as financial advisor on the part of the initial purchasers; once that epiphany takes place, the parties tend to resolve their differences quickly and without unnecessary drama.

Involvement of the company's CFO and financial and accounting staff in this process is essential. Rarely will company counsel be able to anticipate all of the specific flexibility the company needs. Even the so-called boilerplate can be important in this regard and it is a good practice to spend time thinking about all of the reasonably foreseeable transactions and activities in which the company may engage and to test these under the proposed note terms to see whether they are permissible. A few of the areas worth exploring in this regard are:

- Future acquisition, joint venture and investment plans;
- Future financing plans including equipment financing, sale leaseback transactions and other secured debt arrangements;
- Debt or debt-like arrangements incurred in the ordinary course of business;
- Future operations outside the United States;
- Need for letters of credit and other credit enhancements;
- Anticipated funds flow between and among affiliated companies;
- Potential new lines of business; and
- Potential related party transactions.

It is also important to harmonize the note terms with the covenants and other provisions applicable to existing company debt instruments, such as secured credit facilities, recognizing of course that they will differ somewhat due to the inherent difference in the securities covered. Having flexibility in your credit agreement will do you little good if the same transaction requires consent under your indenture. Indeed, given the difficulty of getting waivers under indentures, failing to get the language right in an indenture can dictate corporate actions for years to come in ways that were not anticipated.

E. THE ROAD SHOW AND PRICING THE OFFERING

The road show is a seemingly interminable series of investor meetings that occurs in a seemingly impossibly compressed period of time. Typically lasting from three days to two weeks, the company will make up to six different presentations in one or more cities each day and will typically move onto one or more different cities for the next day. And then repeat, repeat, repeat. The best that can be said about it is that it does end, and that its success can — and usually will — make or break the offering.

Lawyers are typically not invited to attend the road show presentations or comment on the presentation slides. Given that dynamic, it would be good if the voice of the CFO's conscience bore some resemblance to that of company counsel as demonstrated in the drafting process.

The road show culminates in pricing the offering. Logistically, this means executing the purchase agreement. While the company has been on the road show, company counsel will have been negotiating the purchase agreement on the company's behalf. The terms of a typical purchase agreement are such that they do not vary greatly from transaction to transaction. The most significant aspect of the purchase agreement, beyond the price of the securities, is the dramatic and temporary change it engenders in the relationship between the company and the initial purchasers. Prior to executing the purchase agreement, the company and the initial purchasers have, at best, an informal arrangement to do a deal if there is a deal to be done. Either party can walk away at any time with no liability. Once the purchase agreement is signed, the parties are bound to close, absent extraordinary circumstances, on the designated date (typically the third business day after pricing, or T+3, but sometimes up to nine business days later, or T+9).

F. CLOSING

The closing of a high yield offering is relatively uneventful. The most significant aspect of the closing is the necessity of closing on time. Failing to close in a timely fashion is so extraordinary that no one seriously contemplates it. The notes will already be trading in the market, the parties will be bound by the purchase agreement, and both the initial purchasers and the company will feel, quite rightly, that their reputations are on the line.

The mechanics of closing are as follows: the night before, company and initial purchasers' counsel meet to collect all relevant documents, which by that time have been finalized and, for the most part, executed. During that pre-closing (or very early on the closing date), the initial purchasers' and their counsel will initiate a bring-down due diligence call in which they will ask the company whether there have been any material developments since the pricing. Hopefully, the honest answer will be "no," and the call will be short. On the morning of pricing, the initial purchasers will wire the funds, the trustee will authenticate the notes and the company, the trustee and the initial purchasers will telephonically instruct The Depository Trust Company, or "DTC" (the keeper of the electronic records of the notes), to release the notes. It all typically happens before noon eastern time.

A word of caution regarding closing: the one piece of paper that can't be faxed and can't be done without is the DTC "Letter of Representations." While not a complicated document, DTC can be very particular about having an original copy in just the proper form and in its possession with an original signature prior to the closing. Experienced company counsel will ensure that this is taken care of properly.

CHAPTER III
THE OFFERING MEMORANDUM

The offering memorandum will generally look very much like a prospectus for a registered public offering. For a first-time issuer, it will contain all the items required for a prospectus contained in an SEC Registration Statement on Form S-1. For a seasoned issuer, it might be limited to those items required for a Registration Statement on Form S-3, including documents incorporated by reference. It is fair to ask why this is the case. The answer is two-fold: first and foremost, it is what the market demands. While the notes issued in a high yield offering are initially done so as a private placement, the notes are sold, held and traded much as they would be if they were registered. Second, they will eventually be registered in an A/B exchange transaction as described in Chapter VI. Neither the company nor the initial purchasers are typically comfortable issuing the notes pursuant to an offering memorandum that differs much from the prospectus by which the notes will eventually be registered. When we describe the technical requirements for each section of the offering memorandum in the following pages, we are referring to the requirements that would apply *as a technical matter* if the offering were registered; we are also describing the requirements that do apply *as a practical matter* given market practice with regard to the unregistered initial offering done through the offering memorandum.

Given the substantial similarity between the private offering memorandum and the prospectus for a registered offering, one might assume that the liability is the same or similar in the two offerings. One would be wrong. Under the 1995 *Gustafson v. Alloyd* case, the Supreme Court held that '33 Act liability can only attach in a registered public offering, leaving buyers in a private placement with only Rule 10b-5 under the '34 Act to rely on for their remedies. This is not irrational, as the buyers in an initial high yield offering are invariably QIBs, who are regarded under the federal securities laws as sophisticated investors able to fend for themselves. Rule 10b-5 requires *scienter* (knowledge or reckless disregard) on the part of the seller, as compared to the '33 Act remedies, which can carry strict liability for the issuer and allow a due diligence defense (as opposed to an ignorance defense) for others involved, including directors and officers.

Whether the 10b-5 liability that attaches in the private placement is converted into Section 11 liability in an A/B exchange is an interesting question, given that the only consideration given in the A/B exchange is the private note with its inherent 10b-5 remedy attached. While the policies behind *Gustafson, Exxon Capital* and Rule 144A itself (discussed in Chapter IX) would each suggest for its own reasons that investors in high yield notes do not have or need the protection of the securities laws beyond Rule 10b-5, it is difficult to reach the conclusion that completing a registered public offering, *i.e.,* the A/B exchange, does *nothing* with respect to the issuer's liability, or that, as a registered public offering, it is not attended by the remedies available *by statute* to purchasers in a registered public offering. Yet when presented with that precise question, a least one court, in the *In re Safety-Kleen Corporation Bondholders Litigation*, dismissed a Section 11 claim on the grounds that (1) no damages could be demonstrated because the exchange involved two sets of identical bonds and (2) there was no reliance because the investors' decision to exchange one set of bonds for another did not depend on the veracity of the registration statement. While these distinctions are important to lawyers and can be important to the outcome of securities litigation, as a practical matter, all parties will want to take as much care in the preparation of an offering memorandum used in the initial sale of the notes as in the preparation of the prospectus used in the registered A/B exchange.

Finally, a word about "plain English." Under its former chairman, Arthur Leavitt, the SEC adopted a set of rules and policies regarding the presentation of information in a prospectus generally referred to as the "plain English" rules. These rules have now generally been assimilated into the investment community and most participants understand them fairly well. While most practitioners would agree that the rules have generally improved the readability of prospectuses and offering memoranda, most would also agree that in their application, the SEC exhibits a certain rigidity about some seemingly inconsequential language requirements. Thus, you will often find the working group objecting to what you might find to be a perfectly legitimate way of phrasing a particular concept. This is particularly true with regard to industry acronyms or technical terms that you believe are well understood but that counsel will tell you must be spelled out or explained. As an extreme example of this, one of the authors has had the experience of having the SEC staff object to the term *cell phone* — in an offering by a wireless communications company! Plain English is like the law of gravity . . . it is much easier to obey than to understand.

A. BOX SUMMARY

Often referred to as the "box," because of the box that traditionally surrounds each page of the summary, the box summary is considered by many to be the most important part of the offering memorandum because it is often the only part that is read by investors. The box summary, while typically only six to eight pages long, will occupy up to 50% of the time spent in drafting sessions. Be heartened that the other 90 or so pages don't receive the same level of attention. If the CEO or other senior managers want to limit their time in reviewing and contributing to the early drafts of an offering document, this is the section on which they should focus. What is written in this summary, especially as it relates to the company's business and strategy, will become the basis not only for the remainder of the document but for the roadshow presentations and the entire marketing effort. It is also not unusual to find that the drafting of this section can be a healthy undertaking worthy of senior management's attention that may even evolve into a rethinking or refinement of the company's actual business strategy.

The technical requirements for the box summary are contained in Item 503 of Regulation S-K. A quick read of Item 503 will tell you that there are no technical requirements. The most compelling guidance comes from the instruction to Item 503(a), which reads as follows:

> The summary should not merely repeat the text of the prospectus but should provide a brief overview of the key aspects of the offering. Carefully consider and identify those aspects of the offering that are the most significant and determine how best to highlight those points in clear, plain language.

That is all the issuer has to go on. In practice, the box summary typically starts with a two- or three-page description of the company and its business strategy. That company description is then followed by a two-page summary of the transaction. Finally, there are one or two pages of summary financial data. The summary financial data is often identical to the selected financial data, although it commonly eliminates the first two years of the five-year period required in the selected financial data section or condenses the line items presented. Pro forma financial information is also commonly presented in one or more columns, as is data for the latest twelve-month, or “LTM,” period.

B. RISK FACTORS

The box summary will be immediately followed by a risk factor section, typically seven to fourteen pages in length. It may appear to contain risks that seem too obvious to mention and risks that seem too remote to be of any concern. There are many reasons to include a particular risk factor, not least among them the fact that one of your competitors or another company in a comparable line of business included a similar risk factor. The quality of disclosure is often thought to rest on an “objective” or “reasonable man” standard, *i.e.*, what a hypothetical prudent investor would consider important to an investment decision. It is hard to argue that a risk would not meet that standard when three of four offering documents for similar businesses described that risk.

The risk factors will start or end with three or four pages of risks relating to the notes and the offering. These will range from a risk factor about high leverage, to risk factors about “fraudulent conveyance” laws, to risk factors about the market for the securities. These risk factors will often be copied to a large extent, word for word, from comparable deals. This is not only typical, but appropriate, because the risks presented are structural and are, in fact, the same from deal to deal. The only information necessary from the company will be specified financial data such as total debt as of a given date or the ratio of earnings to fixed charges. Care should be taken, however, to not view these risk factors as mere boilerplate and to make sure they do in fact apply to your situation and are tailored to any particular issues raised by your offering.

The remaining risk factors will be specific to the company or its industry. As mentioned above, many of these risk factors will be gleaned from comparable deals but tailored to the company’s particular situation. The working group should also brainstorm additional risk factors. Finally, these risk factors should generally be presented in their order of importance.

The technical requirements for risk factors are also contained in Item 503 of Regulation S-K. Once again, the requirements are few (the most significant requirement is that the risk factors directly follow the box summary). Again, as a technical matter, risk factors are not actually required. Universal market practice, however, is to include them. Omitting the risk factor section is not a practical option.

Company executives are often tempted to mitigate risk factors, omit individual risk factors or otherwise tone them down. This is really not a good idea. People often say that risk factors are “cheap insurance” because by simply disclosing these risks you can greatly mitigate the potential securities law liability that might otherwise arise if the company should fall subject to them. That is not really an accurate analogy, as the risk factors don’t insure anything. Think of them as the rickety rails on a rope bridge hanging over a deep canyon. You don’t want to lean on them too heavily, but you wouldn’t want to do without them.

In all cases, risk factors should be tailored to reflect the risks discussed during the due diligence process. When the issuer is already a reporting company that has risk factors in prior offering documents or in ’34 Act reports, you will still want to examine the risk disclosure anew and make sure that it is both up to date and reflective of whatever risks have been identified by the working group for the offering. Some securities plaintiffs’ lawyers will use a history of unchanged risk factors as evidence for the proposition that the company viewed this disclosure as mere boilerplate that was never updated or seriously focused on by the issuer.

Perhaps the greatest frustration that company managers have with risk factors, aside from the fact that there are so many of them, arises from the SEC’s position that risk factor disclosure should not contain any language that mitigates the risk. In other words, you only get to talk about what might go wrong, not about the many facts and circumstances that make the risk unlikely and not about the steps that could be or have been taken to mitigate it. This is a counterintuitive mandate for most company executives. Some comfort can be taken from the widespread recognition by readers of disclosure documents that the risk factor section is going to be entirely negative.

C. PRO FORMA FINANCIAL DATA

Pro forma financial data recasts the company's financial statements "as if" a particular transaction or other state of affairs had occurred at the beginning of the period presented (in the case of income statement data) or as of the last balance sheet date (for balance sheet data). Investors will rely heavily on pro forma financial data because they are primarily interested in the company's performance going forward, and when a significant transaction has taken place that is not fully reflected in the company's historical financial statements, those statements become less predictive of performance going forward. Pro forma financial data help to normalize the historical financial data for the current state of affairs.

Pro forma financial data is not always necessary. The technical requirements for pro forma financial data are contained in Article 11 of Regulation S-X. Under Article 11, pro forma financial information is required, among other things, when a "significant" acquisition occurred during the most recent fiscal year or interim period for which financial data is presented, or is "probable." Significant for these purposes means applying the conditions described in Chapter I, Section A.1. at the 20% level.

D. MANAGEMENT'S DISCUSSION AND ANALYSIS

Management's discussion and analysis of financial condition and results of operations, or "MD&A," is intended to provide management's insight into the company's financial performance and position. MD&A ranks a close second to the box summary as the most widely read section of the offering memorandum. A well-written MD&A provides tremendous insight into not only the company's historical financial performance but also its likely future performance. Investors want to understand not only what your results were, but how you got them and whether the factors that led to them are changing.

The technical requirements for MD&A are contained in Item 303 of Regulation S-K. MD&A, typically 10 to 15 pages in length, usually starts with an introduction describing the company's business in brief terms and any additional information that is important to understanding the company's financial results. For example, a company with an active acquisition history might lead off with a brief discussion of those acquisitions and their impact on the comparability of periods prior to the acquisitions.

The introduction will normally be followed by a period-by-period analysis of the company's operating results. This analysis will typically describe each significant line item in the company's financial statements and compare that line item for the applicable period to the comparable prior period. The requirement is to explain not only *how much* the amounts changed, but *why*. For example, the classic MD&A discussion of a revenue increase would address whether revenue increased because of increased prices, volume, or both, and quantify the effects of each.

MD&A will also contain a discussion of the company's liquidity and capital resources. Unlike the period-by-period historical analysis described above, this section has a forward-looking element to it. This section should discuss both the company's capital resources as they relate to the company's capital needs going forward and any "known trends and uncertainties." This section is of particular relevance in a high yield offering memorandum as the investors will be keen to understand the company's capital structure going forward in order to evaluate the credit.

MD&A will also often contain a section describing the company's exposure to market risk. This will typically be applicable to companies that are highly leveraged, and therefore exposed to significant interest rate risk, or are dependent on commodity raw materials, and therefore exposed to commodity price risk. This section will demonstrate the impact on the company of significant movements in the interest rate or commodity price to which they are exposed.

E. BUSINESS

The business section, as the name would imply, describes the company's business and operations. The technical requirements for the business section are contained in Item 101 of Regulation S-K, but the typical business section contains much more information about the company than Item 101 would appear to require. The format for business sections varies significantly from one deal to the next, but this section is typically 10 to 15 pages in length and contains a one- or two-page brief description of the company followed by a description of the company's business strategy modeled after, but often an expansion on, the box summary. Often following this introductory material will be descriptions of the company's products and services, the competitive landscape, the company's information technology capabilities, its production facilities and various other aspects of its business. This section will also often contain a discussion of the industry in which the company operates. After the box summary and the MD&A, the business section will probably occupy more of the working group's attention than any other section of the offering memorandum.

F. MANAGEMENT; CERTAIN RELATIONSHIPS

The management and certain relationships sections are highly technical descriptions of the company's directors and officers, how they are compensated and what other relationships they may have with the company. Governed by Items 401, 402, 403 and 404 of Regulation S-K, the management section will begin with a series of brief biographies of the company's officers and directors and, optionally, its key employees. These are not resumes — they are responsive to a technical requirement, and must include the person's business activities for the past five years and any directorships of other public companies. Educational background is not required, nor is a comprehensive discussion of the person's entire career. Having said that, you can go beyond the technical requirements in certain cases to list relevant and compelling qualifications or experiences.

The biography section is followed by a discussion of management compensation. For managers of heretofore private companies, this may come as an unwelcome surprise. The technical requirements of this section are quite detailed, and experienced company counsel will help parse the details. Suffice it to say that extensive disclosure will be included about the compensation of the senior managers (the CEO and top four most highly compensated other than the CEO) and their ownership of the company's securities.

The offering memorandum must also contain a description of any business relationships between the company and its officers, directors and principal stockholders. Once again the technical requirements are quite detailed.

G. DESCRIPTION OF OTHER INDEBTEDNESS

The offering memorandum will often contain a description of other company indebtedness. This is not technically required but, because investing in the high yield offering is a credit decision on the part of investors, it is considered useful and material. This section is typically one to three pages in length and contains a moderately detailed description of the company's senior credit facilities, as well as any other indebtedness or preferred stock that would be relevant to a credit decision. This section is often somewhat duplicative of the liquidity and capital resources portion of MD&A but generally provides a more detailed discussion of the other credit arrangements, particularly as they may affect the rights of the high yield note investors.

H. DESCRIPTION OF NOTES

The description of notes will be forty or more pages in length and will contain, more or less verbatim, the operative language of the indenture. This section is described in detail in Chapter V below.

I. OTHER

The offering memorandum will also contain a number of other sections, such as use of proceeds, selected financial data, plan of distribution and the like. While these sections are important in their own right, we have omitted a detailed description of them as they tend not to occupy a great deal of the working group's time and attention.

CHAPTER IV
THE CREDIT PARTIES

Before entering into the detailed discussion contained in Chapter V of the important covenants contained in a high yield indenture, it is important to understand the structure of the high yield credit and how various categories of credit parties relate to the indenture and the credit.

In order to understand the high yield structure one must grasp the concept of the "system," *i.e.*, the issuer and the guarantors (and, for some purposes, nonguarantor restricted subsidiaries), but excluding any unrestricted subsidiaries (each of these parties will be discussed in detail below). The high yield indenture generally regulates the flow of money outside of the system (including the obligation to repay debt to parties outside of the system) and allows the free flow of money among parties inside the system. Many professionals liken the high yield indenture to a plumbing system, which, while an imperfect analogy, helps in understanding the concept of free circulation within the system and the prevention of leaks.

A. THE ISSUER

The threshold question in establishing the high yield credit party structure is determining who should issue the notes. For existing public companies, the issuer will typically be the public company itself. For nonpublic companies, the matter is less clear. If the parent company in the corporate chain is also a fully functioning operating company, the parent company is still likely to be the issuer. If the parent company is a pure holding company, the question becomes more complex. A typical outcome is that the issuer will be a second-tier operating/holding company, with all subsidiaries guaranteeing the debt and, possibly, a parent guarantee, although the parent guarantee creates some complications under the Sarbanes-Oxley Act as discussed in Section B of this chapter. The principal driver behind this structure will be the desire on the part of the company's senior lenders to be lower in the capital structure, and therefore closer to the operating assets, and the noteholders' desire to be at the same level as the senior debt.

B. GUARANTORS

High yield notes are often guaranteed by most if not all of the company's domestic subsidiaries, and sometimes by the issuer's parent company. The purpose of the guarantee is to bring the obligations further down in the company's capital structure and therefore even closer to the company's operating assets.

The question of whether to issue a parent guarantee is both a credit decision and a financial reporting decision. The credit enhancement of a parent guarantee when the parent is a pure holding company is less than compelling, nonetheless some initial purchasers may recommend it to enhance their marketing of the notes. The question of whether to provide a parent guarantee is also influenced by the banks' desire to get a pledge of the operating company's common stock, which is thought to require some obligation on the pledgor's part to be effective. To support that pledge, the banks may demand a guarantee of the bank debt, and if the banks have a guarantee, bond buyers will demand one as well. If the parent does not guarantee the securities, the issuer must provide financial reports that are not consolidated with the parent company but are consolidated with all subsidiary guarantors. If the parent does guarantee the notes, the issuer may report consolidated financial statements at the parent company level, simplifying its reporting requirements.

Issuers are also influenced by the requirements of the Sarbanes-Oxley Act of 2002, which are only applicable to the parent if there is a parent guarantee (assuming that the parent is not itself a public reporting company subject to Sarbanes-Oxley). In particular, Sarbanes-Oxley prohibits loans to executive officers, which can adversely impact the company's ability to provide tax-efficient management equity to its executives. For this and other reasons, parent guarantees are becoming less common when the parent is not a reporting company.

The enforceability of the guarantees may be limited by applicable "fraudulent conveyance" laws. The purpose of these laws is to protect the other creditors of the guarantor. These laws generally provide that if a guarantor did not receive adequate value for its guarantee, the guarantee may not be enforceable. Legal practitioners generally believe that the guarantee of indebtedness incurred to finance the consolidated group is supported by the parent's implicit promise to provide liquidity and other support, financial or otherwise, when needed, but none believe it so strongly as to write a formal legal opinion on the subject. Fraudulent conveyance risk is a risk that the market has learned to accept as inherent in the guarantee structure.

C. NONGUARANTOR FOREIGN SUBSIDIARIES

Federal tax rules effectively prohibit the guarantee of a domestic company's indebtedness by a foreign subsidiary. This is because, to the extent such indebtedness is so guaranteed, the earnings of that subsidiary, whether or not distributed to the parent company, will be treated as a "deemed dividend," increasing the company's federal income tax obligations. This result is well understood by high yield professionals, and the inability of foreign subsidiaries to issue guarantees is not (or at least should not be) controversial.

D. RESTRICTED SUBSIDIARIES

The term *restricted subsidiary* is a bit misleading. Restricted subsidiaries are "restricted" in the sense that they are governed by the terms of the indenture; they are not "restricted" in the sense that they are freely able to transact with other restricted subsidiaries. Think of them as being "in the system," rather than being "restricted." Generally, all subsidiaries of the issuer will be restricted subsidiaries unless designated as unrestricted subsidiaries, including both guarantors and nonguarantors. This means that all income produced by these subsidiaries is counted for purposes of compliance with the various covenants described in Chapter V, and these subsidiaries are all limited in their ability to take the various actions that are limited by those covenants. The distinction between guarantors and nonguarantor restricted subsidiaries is more subtle. Some actions, such as making restricted payments, are, to the extent permissible at all, permitted by any restricted subsidiary. Other actions, principally the incurrence of indebtedness, are limited to guarantors when permitted at all. This is to avoid allowing the notes to become structurally subordinated to other indebtedness.

E. UNRESTRICTED SUBSIDIARIES

Unrestricted subsidiaries are the mirror image of restricted subsidiaries. These subsidiaries are treated as "outside of the system," and therefore are not restricted in what they can do, but at the same time they are not permitted the freedom to freely interact with the credit parties inside the system as are restricted subsidiaries. Thus, the income from unrestricted subsidiaries does not support the consolidated group's compliance with the high yield covenants, all transactions with the unrestricted subsidiary must be permitted by the transactions with affiliates covenant and any capital contributions or loans to, or guarantees of the indebtedness of, the unrestricted subsidiary are restricted as investments in the unrestricted subsidiary. Many issuers will look to the creation of an unrestricted subsidiary to solve a perceived problem under the indenture only to find that the formation of an unrestricted subsidiary causes more problems than it solves.

That said, having the ability to form unrestricted subsidiaries is a useful feature in an indenture. If a company wants to start another line of business or perhaps the same line of business in another jurisdiction and wants to separately finance these operations, the unrestricted subsidiary vehicle can be a way to do this. Investors have become somewhat leery of this feature, however, because in recent years many issuers used unrestricted subsidiaries to repurchase the company's high yield debt on the market at deep discounts, thereby avoiding the obligation to redeem all of this debt at par or a stated redemption price under the indenture. Care should be taken on both sides of the transaction as to whether an unrestricted subsidiary concept is warranted and, if so, when and how restricted subsidiaries can be designated as unrestricted, and vice versa, and when and how the issuer or its restricted subsidiaries can fund unrestricted subsidiaries.

CHAPTER V
THE COVENANT PACKAGE

On the surface, high yield covenants look much like the restrictions you might find in any credit agreement. They are not. Credit agreements generally contain a mixture of "maintenance" covenants and "incurrence" covenants. A "maintenance" covenant requires the credit party to maintain or achieve a certain level of financial performance to avoid default. Thus, a typical credit agreement might require the debtor to maintain a certain level of revenue or a certain ratio of earnings to fixed charges. "Incurrence" covenants, on the other hand, are only measured when the debtor proposes to undertake some action, like incurring additional debt or making a restricted payment.

While no one would argue that a high yield indenture is not restrictive, issuers can at least take some comfort in the fact that, because all high yield covenants are incurrence covenants, an issuer can not violate a high yield indenture by inaction alone — payment defaults aside, the company must take some action (or omit to take a follow-on action required as the result of some other action) in order to default under the high yield indenture. Poor, even pitiful, financial performance in and of itself will not cause a default under the typical high yield indenture.

The other critical distinction between a credit agreement and a high yield indenture is the time horizon of the instrument and flexibility to amend once issued. The credit agreement usually carries a term of five years or less; the indenture is usually seven to ten years in duration. The credit agreement can be, and often is, amended with some regularity; the indenture may only be amended by effecting a consent solicitation, which is costly and time consuming. Thus, the indenture, of necessity, should accommodate the company's growth over an extended period, and should allow actions that may not be part of the company's immediate business plans.

It is helpful to understand the overall "philosophy" of a high yield covenant package. The fundamental goal is to protect the bondholders by prohibiting actions by the issuer and its restricted subsidiaries that could be detrimental to their ability to repay the bonds and service the interest thereon. Each of the primary covenants is designed to safeguard against a particular set of acts that could have this effect. To put it in plain English and subject to numerous exceptions and qualifications, through the typical high yield indenture covenant package, the bondholders are in effect saying:

- Do not further leverage the business — we are investing in these bonds based on your current and planned borrowings;
- Do not distribute or invest your assets outside of your own business — we would rather have you use these "extra assets" to repay us;
- Do not sell assets unless you use the proceeds to reinvest in the business, reduce indebtedness or repay us;
- Do not incur any more liens — your assets are much more valuable to us if they remain unencumbered;
- Do not cut sweetheart deals with your affiliates — these transfer value away from the business and we get nothing in return;
- Do not allow your subsidiaries who have not guaranteed our bonds to guarantee other debt of the issuer — we cannot let you subordinate us to such debt by giving it a direct claim on the assets of these subsidiaries;
- Do not allow restrictions to be placed on your restricted subsidiaries that make it harder to get money upstream to repay us and service our interest payments; and
- Do not sell stock in your restricted subsidiaries — we want to have the only equity claims against these companies through our position as creditors of the issuer.

The reason it takes many pages to make these simple statements is that businesses operate in a complex world and you need many carefully crafted exceptions to these general rules to allow for this reality. The other factor is that, as lawyers are fond of pointing out, the language matters. Given the amount of money generally at stake under a bond indenture, litigation over language is not uncommon. Careful consideration and drafting at the front end can save or at least minimize the risk of costly and unpredictable litigation down the road.

A. THE INDEBTEDNESS COVENANT

The indebtedness covenant and the restricted payments covenant are the two most important covenants in the high yield indenture. The indebtedness covenant is important because additional indebtedness dilutes the claims of the high yield bonds being issued under the indenture against the assets and cash flow of the issuer and guarantors. In addition, increased debt service requirements can weaken the credit rating to the detriment of the market value of these bonds. Indebtedness generally includes all borrowed money, capital leases and most other types of obligations to pay money. It does not, however, generally include ordinary course trade payables or other debts routinely incurred and retired in the ordinary course of business.

The indebtedness covenant generally restricts the issuer and any restricted subsidiary from incurring additional debt except in two circumstances: first, if the issuer meets the "coverage ratio exception," the issuer and any guarantor will be permitted to incur "ratio debt"; and second, the issuer and other credit parties may generally issue "permitted debt" at any time.

The coverage ratio exception allows the issuer and any guarantor to incur unlimited additional indebtedness so long as, after giving pro forma effect to the additional indebtedness, it meets the defined ratio of earnings before interest, taxes, depreciation and amortization ("EBITDA") to fixed charges (the "coverage ratio"). The defined coverage ratio is most commonly 2.0 to 1.0, but sometimes it is higher or "steps up" over time to higher ratios in subsequent years. Issuers typically are not eligible for the coverage ratio exception at the time they issue the notes and thus must look for another exception to incur debt in the immediate post-issuance period. The reason for this is that the investors in the high yield bonds being issued under the indenture do not want additional debt issued unless and until the issuer's ability to take on and service more debt is meaningfully enhanced through growth in profitability and cash flow.

The typical indenture also allows various types of "permitted debt." This is debt that the issuer may incur regardless of its recent performance or financial condition. Permitted debt generally falls into two categories: technical debt that is not otherwise intended by the indenture to be prohibited, and limited debt baskets that are permitted in pre-defined dollar amounts.

There are a number of items that are technically indebtedness, but which no one believes should be prohibited by the indenture. These include transactions such as the inadvertent writing of a bad check (technically creating debt to the bank that cashes it). There are also a number of types of indebtedness that everyone agrees are debt, but that the company should be able to incur, such as guarantees of indebtedness otherwise permitted by the indenture to be incurred. The initial draft of the description of notes will contain a few such exceptions; experienced company counsel will negotiate for many more. Note that some indentures categorize some of these carveouts as "permitted indebtedness," while others carve the item out of the definition of indebtedness altogether. The high yield indenture requires a careful and informed reading to fully understand its nuances on this point.

Permitted debt will also include a number of specified dollar "baskets," including (perhaps) a basket for local currency debt issued by foreign subsidiaries (for working capital purposes) and, most importantly, debt issued under the company's senior credit facilities. Most indentures will also contain a "hell or high water" basket that permits a limited dollar amount of debt to be incurred for any reason or no reason at all. Issuers should guard this basket carefully, as hell and high water both occur more often than we'd all like.

One noteworthy issue is whether the various baskets are refillable or one-time only. Obviously, the issuer would prefer to be able to refill the baskets as indebtedness incurred under the basket is repaid. In years past, one-time only baskets were the norm. In recent years, we've seen a movement toward more refillable baskets.

Indebtedness at subsidiaries is often called out for even more restrictive treatment. The reason for this is that debt at a lower-tier company becomes structurally senior to the high yield debt incurred by the higher-tiered issuer (unless the lower tier subsidiary is a guarantor). In other words, the high yield debt becomes "structurally subordinated" to the debt at this subsidiary level. The only claim the high yield debt issuer has to the assets of one of its subsidiaries is a claim as the equity holder of the subsidiary. This equity claim is subordinated to the debt claim of the holders of indebtedness issued by the subsidiary, but can be improved by requiring any financial support from the parent to be made in the form of intercompany loans, rather than equity contribution. Of course, this can also affect the company's tax position and should be analyzed carefully.

The effect of structural subordination is why the selection of the issuer and guarantors as discussed above is so critical. However this issue is resolved, the disclosure document should clearly state the relative seniority of various debt instruments imposed by the level of the issuers within the corporate structure. For example, if the high yield notes are issued by a parent holding company with no upstream guarantees, you would want to have a risk factor explaining that the note holders have no claim on the assets at the subsidiaries other than a potential equity claim, which by definition is subordinated to all creditor claims at the subsidiary level.

B. THE RESTRICTED PAYMENTS COVENANT

The restricted payments covenant is the other key covenant in the high yield indenture. This covenant restricts the flow of money "outside of the system," thereby preserving the company's ability to repay its indebtedness. It is an important covenant because if money, including the very funds raised by the issuer through the high yield offering, can leak out of the system, the high yield debt can very quickly become impaired. Payments restricted by this covenant include dividends to stockholders, investments made in third parties, loans made to third parties and guarantees of indebtedness of third parties. It is also important to note what is not limited by this covenant — acquisitions of companies that become restricted subsidiaries, capital expenditures and most intercompany loans and guarantees.

Like the indebtedness covenant, the restricted payments covenant permits two types of restricted payments: first, payments made pursuant to a growing net income "basket" for restricted payments; and second, identified categories of "permitted restricted payments."

The net income basket generally permits restricted payments to be made in an aggregate amount up to 50% of the company's consolidated net income (less 100% of any loss) in the period (taken as one accounting period) from the time of issuance until the time of the restricted payment. There are a number of nuances to how this amount is calculated, not the least of which is that the consolidated net income will exclude the profit or loss of any unrestricted subsidiary. Thus, if an issuer is interested in being able to make restricted payments — and who isn't? — the designation of a profitable subsidiary as unrestricted is not to be taken lightly.

"Permitted restricted payments" again fall into two categories: restricted payments that should be permitted at any time, like the acquisition of an entity that becomes a restricted subsidiary or the payment of a dividend that was permitted to be paid when declared by the board; and a series of predefined baskets.

The baskets will be bifurcated into two sets: permitted restricted payments *per se* and permitted investments. There are often separate "hell or high water" type baskets for each of these. It is important to remember that investments are restricted payments, and thus the issuer can aggregate the two baskets when attempting to make an investment that is too large to be permitted under one or the other.

One note about joint ventures: they tend to create difficult interpretive questions under the indenture and, as written, most high yield indentures allow limited flexibility for joint ventures. The reason for this is that bondholders do not want cash removed from the issuer's balance sheet and invested in an entity that is not controlled by the issuer and subject to the covenants of the indenture. Control in the context of a joint venture unfortunately is often not a black and white issue as certain matters may fall within the control of one party or the other and other matters may be jointly controlled. Issuers for whom joint ventures are a serious option will need to provide for necessary flexibility in the drafting of this and other covenants and, after the fact, parse the indenture carefully when attempting to form a joint venture.

C. THE DIVIDEND STOPPERS COVENANT

The dividend stoppers covenant is among the more abstruse of the covenants in a typical high yield indenture. It is designed to ensure that the cash generated by restricted subsidiaries can flow up to the issuer for payment of the notes, unencumbered by limitations other than those imposed by law or other routine limitations. Because a parent company's claim on its subsidiaries' assets and cash flow is typically only that of an equity holder, the only way for a subsidiary to get cash upstream to its parent is by paying a dividend. Thus, the dividend stoppers covenant attempts to ensure that there are no limits on a subsidiary's ability to declare and pay dividends. This is not usually a practical problem for an issuer, save one important exception — the joint venture. It is typical of a joint venture arrangement for the joint venture partner (even a minority partner) to have some measure of control over the joint venture's ability to pay dividends. This would not be permitted by most dividend stopper covenants, and has itself been the "final straw" breaking the back of many proposed joint ventures. The typical structural response to this issue is to form a joint venture as 50% or less owned by the parent, thereby making it a nonsubsidiary and therefore not subject to this covenant. Of course, that also has the effect of causing any investment in that subsidiary to be a restricted payment under the indenture, thereby once again proving that you can't have your cake and eat it too (no matter how good your lawyers are!).

D. THE LIMITATION ON LIENS COVENANT

The limitation on liens covenant is almost identical, both in form and intent, to the similar covenant contained in all credit agreements. The covenant will generally restrict the company's ability to grant liens (other than permitted liens) on its assets unless the company grants an equal and ratable lien to the holders of notes. The challenge in the high yield context is to cause the definition of *permitted liens* to match up as exactly as possible to the same definition in the company's credit agreement. Depending on the views of initial purchasers' counsel on this subject, this can be as easy as incorporating that definition by reference or cutting and pasting that definition verbatim, or as hard as negotiating each line item word for word. In either event, the business deal should be that there can be no lien that would be permitted by the credit agreement that would not be permitted by the indenture, and that there may be some permitted by the indenture that would not be permitted by the credit agreement.

E. THE ASSET SALES COVENANT

The name of the "limitations on asset sales covenant" is actually quite misleading. While styled as a prohibition on the consummation of asset sales, in practice the covenant for the most part serves merely to define the acceptable use of the proceeds from asset sales. Generally, the proceeds must be used to permanently repay debt (not necessarily the debt issued under the indenture) or to purchase "replacement assets." The term *replacement assets* is almost equally misleading, as it is not limited to assets replacing those sold; rather, it generally includes any assets that will be used in the company's business.

These covenants also typically provide that assets may be sold only for consideration consisting primarily (75% to 85%) of cash. Asset swaps may or may not be an acceptable alternative to a cash sale. In any event, this covenant will require that assets be sold for their fair market value.

To the extent the proceeds of asset sales are not used in accordance with the covenant, the issuer must use the proceeds to make a tender offer to purchase the outstanding notes at a price equal to their face value plus any accrued interest. It is common to negotiate for some basket amount of proceeds that does not have to be reinvested but this is usually a relatively small amount. Because the company can usually find a use for the cash permitted by the covenant that will be more productive than offering to repurchase the notes, such an offer is rarely made in practice.

F. THE TRANSACTIONS WITH AFFILIATES COVENANT

The transactions with affiliates covenant, like the asset sales covenant, does not actually prohibit transactions with affiliates; rather, it imposes conditions on the consummation of such transactions. The conditions to completing a transaction with an affiliate of the company are typically as follows: (a) the transaction must be on an arms'-length basis, and (b) receipt of the following approvals: (i) below a certain dollar threshold (usually \$5 to \$15 million), none; (ii) above a certain dollar threshold (usually \$25 to \$50 million), board approval and a fairness opinion from a financial advisor; and (iii) between those two figures, board approval. Board approval in these instances will be defined to mean the approval of a majority of the directors who do not have an interest in the transaction.

G. OTHER COVENANTS

The indenture will also contain a number of other covenants, from the mundane (maintenance of existence, delivery of compliance certificates, etc.) to the substantive (equity clawback, no call periods and optional redemptions, etc.). While these covenants are important and will be the subject of some negotiation, they do not typically occupy the same amount of attention as the foregoing covenants.

CHAPTER VI
THE A/B EXCHANGE

The typical high yield offering is structured as a private placement to the initial purchasers under Section 4(2) of the '33 Act, followed by a resale by them to qualified institutional buyers, or QIBs, under Rule 144A promulgated under the '33 Act, to institutional accredited investors, or IAIs, under the so-called "Section 4(1-1/2)" exemption or to purchasers overseas under Regulation S. The principal advantage of this transactional structure over a registered initial offering is time; the issuer can brings its securities to market significantly faster, and therefore obtain funding from investors more quickly because the process does not involve SEC review and its associated delays.

For all its advantages, however, the initial private placement carries one significant disadvantage — it makes the notes "restricted securities" under the '33 Act in the hands of those QIBs, though they are able to freely trade the notes among other QIBs, IAIs and foreign investors. Because restricted securities must generally be held for a minimum of one year before they can be resold, investors want to (or need to, under their investment guidelines) own unrestricted securities. Prior to 1988, this would have presented a problem, as the '33 Act permits issuers to register *transactions*, not *securities*, and because the initial sale transaction would have already taken place, the only means available to provide the investors with the ability to sell without restriction would have been to file a resale shelf registration statement and keep that statement effective for a period of years, which is both costly and an administrative burden.

Beginning in 1988, a series of regulatory changes eased this burden significantly. It began with the SEC's issuance of a no-action letter to Exxon Capital Corporation permitting it to register a transaction whereby it offered to exchange a series of pre-existing securities for an identical series of new securities in the second step of what was ultimately a two-step transaction, now known as an "A/B exchange." The registration of this transaction resulted in the new securities not being restricted securities. This technique is not only less costly and burdensome than a resale shelf registration, but it also reduces '33 Act liability because of the applicability of Sections 11 and 12(a)(2) in the latter case. The A/B exchange, combined with the SEC's promulgation of Rule 144A in 1990, has fueled the spectacular growth of the high yield industry.

A. THE EXCHANGE OFFER

In the modern era, a feature of virtually every 144A high yield offering is the subsequent exchange offer made possible by *Exxon Capital*. Designed to meet the requirements of the aforementioned *Exxon Capital* no-action letter, the exchange offer enables the issuer to provide existing noteholders with unrestricted notes under the '33 Act by exchanging their original "Series A" notes with a new set of "Series B" notes. The A/B exchange is accomplished from 120 to 180 days (or longer) after the original transaction pursuant to the registration rights agreement described below. The initial purchasers do not have any meaningful participation in this transaction; it is effected with the aid of company counsel and the trustee, and generally requires far less management time and attention than the initial offering process.

B. THE REGISTRATION RIGHTS AGREEMENT

At the time of the initial sale, the issuer will enter into a registration rights agreement with the initial purchasers requiring it to effect the exchange offer on a timely basis. The registration rights agreement will set forth a series of milestones to be met (filing the registration statement, having the registration statement declared effective and completing the exchange offer) in a specified number of days. If these milestones are not met, the company will be in a "registration default," and will be obligated to pay additional interest on the notes until the registration default is cured. Note that this "registration default" is not an "event of default" under the indenture, and the noteholders' only practical remedy is the payment of additional interest.

Due to the relative novelty of the *Exxon Capital* approach when these registration rights agreements were first becoming accepted by the market, these agreements also contained a "shelf registration" fall-back position, in case the SEC rescinded the *Exxon Capital* letter. While this process has been accepted in the market and by the SEC now for more than 15 years, the SEC staff still mentions possible regulatory activity in this area from time to time, and this fall-back position remains in these agreements.

C. THE REGISTRATION STATEMENT

The exchange offer registration statement is relatively straightforward. It will usually use the language of the offering memorandum verbatim (but updated for the passage of time and change of circumstances), together with standard language regarding the mechanics of the exchange offer. The SEC may or may not review the registration statement, but particularly in the case of first-time issuers, it usually does.

CHAPTER VII
LIVING WITH THE HIGH YIELD INDENTURE

Once the company has issued the high yield notes, there begins a seven- to ten-year period of living with the indenture. Think of it as the gift that keeps on giving. You should keep the length of this period and the difficulty of amending the indenture firmly in mind when you get the urge to rush through the indenture issues during the offering process.

A. ONGOING REPORTING REQUIREMENTS

Once the SEC has declared the exchange offer registration statement effective, the company becomes technically subject to the periodic reporting requirements of Section 15(d) of the '34 Act, until the beginning of the first fiscal year in which it no longer has more than 300 security holders of record. Typically, this will be the fiscal year after the company's registration statement goes effective, in part because the high yield notes are held in book-entry rather than certificated form, which means that there will be only a few holders of record. At that time, the company becomes a "voluntary filer" as far as the SEC is concerned, but must continue to file reports under the indenture's reporting requirements. Even before the registration statement is declared effective, the company is required to deliver analogous reports to the trustee and the noteholders. Issuing a series of high yield notes is, in a very real sense, going public.

A full description of the periodic reporting requirement of the '34 Act is beyond the scope of this document; however, suffice it to say that over the course of a year, the company will need to provide noteholders with current information that, in the aggregate, is the equivalent of the information that was contained in the offering memorandum. One nuance worth mentioning: because the company will not have a class of equity securities outstanding solely by virtue of the high yield offering, the company need not prepare and distribute proxy statements. This does not mean that such a company can avoid having to report items that typically appear in a proxy statement such as executive officer compensation and stock ownership. Instead, it means that much of the information that would ordinarily be contained in a public company's proxy statement and incorporated by reference into the company's annual report on Form 10-K must be physically inserted into the Form 10-K itself.

B. INTERPRETIVE QUESTIONS

As you will have surmised, the high yield indenture is a difficult document to understand and to negotiate. It is equally difficult to interpret when faced with the actual facts and desires of the company on a going forward basis. Interpretive questions arise frequently and do not always have clear answers. Experienced company counsel, preferably the lawyer who negotiated the indenture, can help with these questions as they arise.

C. COMPLIANCE CERTIFICATES

Most indentures require that the issuer provide periodic compliance certificates to the indenture trustee. While the certificate itself is generally very simple and just provides a statement by a designated officer that he or she knows of no default under the indenture, issuers must make sure that someone has this on his or her checklist of compliance items. It should go without saying, but whoever is signing these certificates must be very familiar with the indenture covenants and must either know or inquire as to whether anything has occurred that raises a compliance issue thereunder.

D. AMENDMENTS

As noted earlier, one of the distinguishing characteristics of a high yield indenture is the difficulty of amending it. The reason for this has less to do with the amendment provisions themselves — they are similar to those in any credit agreement and generally require the consent of a majority of the aggregate principal amount of the debt — and everything to do with the fact that the debt is generally traded and held by many holders. Thus, consents to amendments usually require a consent solicitation, which will take substantial time and cost a great deal of money, including a consent payment to the holders, which is, in effect, buying their vote. Like most credit documents, there are also certain provisions, such as those relating to interest rate or maturity, that cannot be amended without the consent of each noteholder.

One curious aspect of the consent provisions is that they do not prohibit so-called "exit consents." A fairly typical transaction is one in which the issuer tenders for the notes during a time in which there is no optional redemption available. In connection with these tenders, tending noteholders usually vote for an amendment to the indenture that eliminates virtually all of the substantive covenants. It is a bit like turning off the lights as you leave a room full of people — rude, but not illegal.

E. DEFAULTS

The events of default are defined in a fairly consistent manner across indentures. There is usually no grace period for failure to repay principal when due, a short grace period (generally 30 days) for interest payment defaults and a similar grace or cure period for covenant defaults. For covenant defaults, however, it is very helpful to the issuer if this period runs only from and after notice by the trustee to the issuer that there is a covenant default. This in effect forces the trustee to discover the covenant default and take action with respect to it. That is why the compliance certificate is an important element of the indenture. This certificate is intended to put the trustee on notice of covenant problems so that the certifying officer, and not the trustee, is policing compliance with the covenants.

Invariably there will also be bankruptcy or insolvency events of default and events of default that arise when the issuer has unsatisfied judgments against it above a specified threshold amount or has other indebtedness above a specified threshold amount that goes into default. On that latter point, the issuer would prefer that the default read such that it occurs only if the other indebtedness actually gets accelerated by the holders of such indebtedness. Issuers and their counsel will push for this "cross-acceleration" approach over the "cross-default" approach because if the issuer can keep another creditor group at bay while it tries to work out a covenant default under that group's documents, it will not have to deal with a simultaneous default under the indenture. In the typical circumstances where a senior secured credit facility has far more restrictive covenants than a note indenture, this distinction can make a major difference because if the company is able to resolve its problems with the senior creditors it may never have one arise under the indenture. A cross-default provision, however, essentially gives the noteholders under the indenture the benefit of the more restrictive covenants in other credit documents.

Once there is a default (other than a bankruptcy or insolvency default, which will trigger immediate acceleration), the trustee or holders of some minimum amount of the notes (typically 25%) must affirmatively accelerate the debt. In the absence of this action, there will be a default with no immediate consequence under the indenture. It is typical for a default situation to remain between default and actual acceleration while the parties try to work out a solution to the problems that caused the default.

CHAPTER VIII
THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act of 2002 and the related SEC rules place a number of obligations on an issuer of high yield notes. Certain of these obligations stem from the company's contractual disclosure obligation under the indenture and thus come into effect the moment the company issues the notes to the initial purchasers. Still other obligations arise only when the company becomes an "issuer" within the meaning of Sarbanes-Oxley, which happens the moment the company files the registration statement for its A/B exchange offer and typically ends immediately after the fiscal year in which the company's registration statement becomes effective. At that time the high yield issuer becomes a "voluntary filer" for SEC and Sarbanes-Oxley purposes, although as noted above, such an issuer is required to continue reporting under the terms of the indenture.

It should be emphasized at the outset that companies that must file periodic reports pursuant to Sections 12(g) or 15(d) of the '34 Act, *e.g.,* most companies with publicly traded equity securities, are by definition "issuers" for purposes of Sarbanes-Oxley and subject to its entire scope of provisions. Because this is often not the case for high yield issuers, we assume in this chapter that the company has not issued other securities that would otherwise subject them to the '34 Act reporting requirements. We sometimes refer to such issuers in this chapter as "high yield–only issuers."

A. PROVISIONS APPLICABLE UPON ISSUANCE OF NOTES

As noted above, by virtue of the covenants contained in the indenture, the company will be required to file various periodic reports with the SEC. Although Sarbanes-Oxley does not apply to voluntary filers because they are not "issuers," the SEC embedded most of its disclosure requirements in the periodic reports themselves. These reports have been impacted by Sarbanes-Oxley in the following respects.

1. CIVIL OFFICER CERTIFICATIONS

Sarbanes-Oxley requires the company's CEO and CFO to certify in each periodic report that they have reviewed the report, that the report is accurate and does not omit information that would render such report misleading and that it has established, maintained and evaluated the effectiveness of its system of internal controls. This "civil certification" is separate and distinct from the so-called "criminal certifications" required under Sarbanes-Oxley. Voluntary filers are not subject to the criminal certification requirements, but are subject to the civil certification requirements.

2. USE OF NON-GAAP FINANCIAL MEASURES

In order to present "non-GAAP financial measures," such as EBITDA, in a filing with the SEC, companies must also present the most directly comparable GAAP measure with equal or greater prominence and provide a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP measure. In addition, companies must also include a statement as to why management believes that the non-GAAP measure provides useful information to investors regarding the company's financial condition and results of operation and, to the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP financial measure. Regulation G, which applies to public statements made outside of a filing with the SEC, imposes similar requirements. Although high yield–only issuers are technically not subject to the requirements of Regulation G, market practice and common sense have led many such filers to voluntarily comply with Regulation G in all of their public statements. Moreover, the SEC has expressed its view that a voluntary filer's noncompliance with Regulation G may raise significant issues with respect to the antifraud provisions of the '34 Act.

3. AUDIT COMMITTEE FINANCIAL EXPERT DISCLOSURE

Each issuer must disclose whether it has an "audit committee financial expert" on the audit committee of its board of directors. Significantly, under the terms of the rules creating this requirement, an individual must not only possess certain attributes in order to be qualified as an audit committee financial expert, but must also have required these attributes through certain specified types of experience. Should a company have such an individual, it must also disclose his or her name and whether he or she is "independent." In the event that a company does not have such an individual on its audit committee, it must disclose why.

4. Code of Ethics Disclosure

Similarly, an issuer must also disclose whether or not it has adopted a code of ethics (meeting the standards promulgated by the SEC) applicable to its principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions. If the company has not adopted such a code, it must disclose why. As a practical matter, this means that all companies subject to this requirement adopt a code of conduct because there is rarely a good reason not to do so. The company must also make immediate public disclosure of any amendments to its code of ethics, any waiver by the company of a material departure from the code by a senior officer or any "implicit waiver," or failure on the company's part to take action within a reasonable period of time regarding a material departure from a provision of its code that has been made known to an executive officer of the company.

5. Disclosure of Off–Balance Sheet Arrangements and Aggregate Contractual Obligations

Issuers must include a separately captioned section within MD&A disclosing all off–balance sheet arrangements that have or are reasonably likely to have a material current or future effect on the company's financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. In addition, the MD&A contained in a company's annual report on Form 10-K must also include disclosure, in tabular format, of known contractual obligations, aggregated by type of obligation and period due. This table need not be repeated for quarterly reports, but must be updated in such reports to the extent that the company's contractual obligations have materially changed.

6. Management's Assessment of Internal Controls

A company's Form 10-K must contain an internal control report affirming management's responsibility for establishing and maintaining adequate internal controls and procedures for financial reporting and stating management's assessment of the effectiveness of the company's internal control structure and procedures for financial reporting. Management's assessment must also be attested to and reported on by the company's auditors. This requirement has resulted in public companies incurring significant expenses associated with the audit firm's attestation requirements. Because a high yield–only issuer is unlikely to be an "accelerated filer" under SEC rules, such issuers are generally not required to meet this requirement until the 10-K for their first fiscal year ending on or after July 15, 2005.

7. Auditor Independence Rules

A number of restrictions have been placed on the relationship between a company and its audit firm in the name of auditor independence. These restrictions prohibit an audit firm from providing certain nonaudit services and require that all audit services and permissible nonaudit services be pre-approved by the company's audit committee. Significantly for an issuer of high yield notes, the "comfort letter" typically required by the initial purchasers in connection with a high yield offering is deemed under Sarbanes-Oxley to be a nonaudit service for which prior approval must be obtained. Other restrictions include requirements that: (1) certain partners at the audit firm who are involved in the company's audit be periodically rotated; (2) the auditors report certain matters, such as the company's "critical accounting policies" to its audit committee; (3) the company disclose the audit and nonaudit fees it pays to its audit firm; and (4) the company not use an audit firm if a person in a "financial reporting oversight role" with the company was on the company's audit engagement team during the year preceding the commencement of the audit. Although technically these auditor independence rules do not apply to voluntary filers, a critical element of an issuer's SEC reporting obligations is the need to provide independently audited financial statements. Therefore, as a practical matter, voluntary filers must comply with Sarbanes Oxley's provisions on auditor independence.

8. Disclosure of Material Correcting Adjustments

Each financial report filed by the company that must be prepared in accordance with GAAP must reflect all material correcting adjustments that have been identified by a public registered accounting firm.

9. Real-time Disclosure of Material Events

Under new (August 2004) SEC rules, the filing deadline of a Form 8-K for most triggering events has been shortened to four business days after the occurrence of such event. The same rules also expanded the scope of triggering events to include entry into and termination of a material definitive agreement made outside the course of ordinary business, events that accelerate a direct financial obligation and impairment to the company's assets (including goodwill) under GAAP.

B. PROVISIONS APPLICABLE UPON FILING OF REGISTRATION STATEMENT

Those provisions of Sarbanes-Oxley that do not apply to a high yield–only issuer until the filing of its registration statement are as follows.

1. Director and Executive Officer Loans

For so long as the company is an "issuer" within the meaning of Sarbanes-Oxley, it will be prohibited from extending or maintaining credit, arranging for an extension of credit, or renewing an extension of credit (directly or indirectly, including through any subsidiary) in the form of a personal loan to or for any executive officer or director. Extensions of credit existing on July 30, 2002 are grandfathered under Sarbanes-Oxley, so long as they are not thereafter materially modified or renewed. Limited exceptions to this prohibition exist, including, for example, for home improvement loans. These exceptions do not include, however, such common business practices as providing relocation loans or extending personal loans to directors or officers to purchase company stock, which for tax reasons is a common practice.

2. Forfeiture of Bonuses and Profits

If an "issuer" is required, as a result of misconduct, to prepare an accounting restatement due to its material noncompliance with its SEC mandated financial reporting requirements, the company's CEO and CFO must disgorge to the company: (1) any bonus or other incentive-based compensation or equity-based compensation received by him or her from the company during the 12-month period following the public issuance of the financial statements that are subsequently restated; and

(2) any profits realized from the sale of the company's securities during that 12-month period. Not that it should be necessary, but the existence of this provision should help explain to the CEO and CFO why the financial and other due diligence conducted as part of the offering process is so critical. It is far better to discover a problem up front, even if it delays or precludes an offering, than to discover it later with the need to restate financial statements and comply with these disgorgement provisions.

3. Improper Influence on Conduct of Audits

New rules enacted by the SEC prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from coercing, manipulating, misleading or fraudulently influencing the auditor of the company's financial statements if that person knew or should have known that such action could render the financial statements materially misleading. Needless to say, undertaking such actions would violate a number of other legal prohibitions irrespective of Sarbanes-Oxley and its associated rules.

4. Criminal Officer Certifications

In addition to the so-called "civil certifications" required of the CEO and CFO in the Form 10-K, Sarbanes-Oxley also requires the same persons to separately certify, upon pain of criminal penalty, that each of the company's periodic reports is in full compliance with the '34 Act and fairly presents in all material respects the company's financial conditions and results of operations.

As noted above, the provisions covered in this section are not technically applicable until a company has filed its registration statement and cease to apply once the company becomes a "voluntary filer" under SEC rules. However, high yield–only issuers should consult with counsel as to whether they should consider complying with certain requirements of Sarbanes-Oxley prior to or after the time such compliance is mandatory. Consider, for example, the ban on the making of personal loans to executive officers and directors contained in Sarbanes-Oxley Section 402. While under its terms, this provision is inapplicable until the filing of a registration statement, a company may, nevertheless, want to implement this ban as its policy before that time in light of the fact that any such loans must be repaid to, or forgiven by, the company at or prior to the time that the registration statement is filed.

C. OTHER CONSIDERATIONS

A full description of the implications of Sarbanes-Oxley is beyond the scope of this document. Needless to say, Sarbanes-Oxley will impact many of the decisions that will be made during the offering process and a prospective issuer will need to rely heavily on counsel familiar with its operation in negotiating its various nuances. By way of example, consider the impact the ban on making loans to executive officers and directors may have on determining the high yield credit party structure. If being able to provide such loans is important to a company, a company will need to consider adopting a two-tier holding company/operating company structure with the notes being issued at the operating company level and the loans being made at the holding company level. Such a course of action would be permissible under Sarbanes-Oxley, provided that the holding company is not also a guarantor of the operating company’s high yield notes.

In addition to the provisions of Sarbanes-Oxley discussed above, there is yet a third family of provisions under Sarbanes-Oxley and associated rule-making efforts by the NYSE and Nasdaq that are not directly applicable to high yield–only issuers. This family includes most of the corporate governance provisions (other than those that are embedded as disclosure requirements in periodic reports), as well as NYSE and Nasdaq requirements regarding majority-independent boards, audit committee composition and the formation of nominating and compensation committees. Because high yield–only issuers typically do not have listed securities, NYSE and Nasdaq rules do not apply to them.

A whole body of SEC statutes and rules continues to apply only to companies with publicly traded equity securities, which again are inapplicable to high yield–only issuers. Chief among these is Section 16 of the ’34 Act, which requires corporate insiders (directors, officers and 10% stockholders) to publicly disclose their transactions in the company’s equity securities and to disgorge profits made on matching purchase and sales transactions made in company securities within six months of each other. Another such provision is Section 13(d) of the ’34 Act which, requires disclosure by persons acquiring a 5% or greater stake in public equity issuer.

The SEC has also adopted rules accelerating the filing deadlines for most large public companies. These rules generally apply to companies that have a public float of $75 million or more. *Public float* is defined as the market value of the company's equity securities held by nonaffiliates as of the last day of the company's last second fiscal quarter. Since high yield–only issuers do not have traded equity securities, they cannot be subject to these accelerated filing deadlines, which will ultimately give them a 30-day extension over accelerated filers when filing their Annual Report on Form 10-K and a 10-day extension when filing their Quarterly Reports on Form 10-Q. Another advantage of being a nonaccelerated filer relates to the transition rules for the auditor's attestation regarding internal controls as required by Section 404 of Sarbanes-Oxley, as the SEC has extended the compliance date for such filers by one year.

For your reference, attached as Appendix C is a table categorizing the various provisions of Sarbanes-Oxley and whether they are applicable to high yield–only issuers.

CHAPTER IX
RULE 144A

As noted in Chapter VI, issuers rely on the exemption from registration provided by Section 4(2) of the '33 Act for the sale of high yield notes to the initial purchasers. The initial purchasers then rely on the exemption from registration contained in Rule 144A promulgated under the '33 Act for the resale of those notes to subsequent purchasers. The importance of this exemption for the initial purchasers is evident by the colloquial alternate name for a high yield offering, which is also commonly known as a "144A offering."

A. REGISTRATION EXEMPTION

Rule 144A exempts the resale of certain securities to qualified institutional buyers, or QIBs, from the registration requirements contained in Section 5 of the '33 Act. Although the exemption contained in Rule 144A is not available to an issuer of notes or other securities, the availability of the exemption for the initial purchasers and other sellers facilitates capital-raising by issuers by permitting greater liquidity in the secondary market.

Initial purchasers and other sellers (other than issuers or dealers) offering or selling notes or other securities in compliance with Rule 144A are deemed not to be underwriters engaged in a distribution and therefore not subject to the registration requirements of Section 5 and the liability provisions of Sections 11 and 12(a)(2) of the '33 Act. Thus, such initial purchasers or other sellers may rely on the exemption from registration contained in Section 4(1) of the '33 Act. Dealers offering or selling notes or other securities in compliance with Rule 144A are deemed not to be participants in a distribution and deemed not to be underwriters, and the notes or other securities are deemed not to have been offered to the public. Thus, such dealers may rely on the exemption from registration contained in Section 4(3) of the '33 Act.

B. QUALIFIED INSTITUTIONAL BUYERS (QIBS)

In order to fit within the safe harbor of Rule 144A, an offer and sale of the notes or other securities can be made only to a QIB or to an offeree or purchaser that the initial purchaser or other seller who is reselling the notes or other securities reasonably believes is a QIB. Generally, a QIB is an institution, such as an insurance company, investment company or investment adviser, that owns or invests on a discretionary basis at least $100 million (or in the case of broker-dealers registered under the '34 Act, at least $10 million) in securities of unaffiliated issuers. In determining whether a prospective purchaser is a QIB, the initial purchaser or other seller is permitted to rely on certain specified nonexclusive methods of establishing a prospective purchaser's ownership and discretionary investments of securities.

C. NOTICE TO INVESTORS

The initial purchaser or other seller of the notes or other securities must take "reasonable steps" to ensure that the purchasers are aware that the notes are not registered under the '33 Act in reliance on the exemption contained in Rule 144A. The cover page of the offering memorandum and a separate section of the offering memorandum entitled "Notice to Investors" will include standard language to put the purchasers on notice that the notes are not registered and are only being offered and sold under Rule 144A.

D. PERMITTED SECURITIES

The notes or other securities being offered or sold under Rule 144A must not, when issued, be of the same class as securities listed on a national securities exchange or quoted on an automated interdealer quotation system such as Nasdaq (other than "pink sheets" trading). Convertible securities and warrants are considered to be securities of the same class as those into which they are convertible or exercisable unless at the time of issuance the effective conversion or exercise premium, as applicable, was at least 10% and, in the case of warrants, the warrants were exercisable for a term of at least three years after issuance.

E. INFORMATION REQUIREMENTS

The holder of the notes or other securities and the prospective purchaser designated by the holder must have the right, upon request, to obtain from the issuer specified information (which information must be "reasonably current") including a very brief statement of the nature of the business of the issuer and the products and services it offers and the issuer's financial statements. The indenture typically contains an undertaking by the issuer to make available, upon request, to any holder or prospective purchaser of the notes information required by Rule 144A(d)(4). Granting the aforementioned information right is not required if the issuer of the notes or other securities is a reporting company under the '34 Act, is a foreign issuer exempt from reporting under Rule 12g3-2(b) or is a foreign government eligible to use Schedule B under the '33 Act.

APPENDIX A

ANNOTATED HIGH YIELD INDENTURE COVENANTS

This document sets forth one example each of several important high yield indenture covenants. In certain respects, what follows is typical of high yield offering covenants. In other respects, it is more pro-issuer than usual. The market and the issuer's particular situation at the time of issuance drive what an issuer can expect to achieve.

The annotations call attention to certain aspects of the covenants and the relevant definitions. In the interest of brevity, not every provision is the subject of an annotation (particularly not the self-evident ones) and not all typical indenture covenants are included. In addition, not all relevant definitions are set forth. The fact that a particular provision has not been annotated or that a particular definition is not included does not necessarily mean it is unimportant.

This document can be used as the basis for a markup, as a source for riders or simply as a learning tool. Its limitations, however, are significant — the following is a nonexclusive list:

- Different investment banks have different forms, which may vary dramatically from this form.
- The market for these provisions evolves over time.
- These documents are context-sensitive. Some carveouts will be highly applicable to one company and not at all to others. Every company has its needs and those needs must be accurately reflected. A well-crafted indenture will be "custom made," not "off the rack," and certainly not "one size fits all."

Negotiating a high yield indenture is unlike most negotiations in that the other party, the investment banker, stands in the middle between the issuer and the bond-buying public. A good banker will understand that the indenture should not unduly limit the company's ability to do business, and everyone, including the company, wants the bonds to sell.

PERMITTED INDEBTEDNESS COVENANT

Limitation on Incurrence of Indebtedness

Issuer[1] will not, and will not permit any *Restricted Subsidiary* to, *incur,*[2] directly or indirectly, any *Indebtedness*[3]; provided, however, that *Issuer or any Guarantor* may incur Indebtedness if, immediately after giving effect to such incurrence, the Consolidated Coverage Ratio *after giving effect to any Pro Forma Cost Savings*[4] is at least 2.0 to 1.0 (this proviso, the "*Coverage Ratio Exception*"[5]).

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[1]Pay close attention throughout to the persons able to incur debt. In this case, Issuer (an operating subsidiary of Parent) and all Restricted Subsidiaries are prohibited from incurring debt. Issuer and Guarantors are able to incur Ratio Debt. For tax reasons, Foreign Subsidiaries will not be Guarantors, and as such are not able to incur Ratio Debt. Parent (a holding company) will not be prohibited from incurring additional Indebtedness. Parent will generally not be a Guarantor because such a guarantee would be itself a "security" that would be registered in the A/B exchange, which would cause Parent to become an "issuer" under the Sarbanes-Oxley Act of 2002 and subject to, among other things, the executive loan prohibitions of that Act.

[2]Note that this covenant prohibits the "incurrence" of debt. It only tests indebtedness on the date it is incurred, and does not require the "maintenance" of any particular level of debt or financial performance.

[3]Pay close attention to the definition of Indebtedness. In many cases, carveouts that you may feel are necessary or have seen in other deals may actually be carved out or not covered by the definition of Indebtedness. See the definition below and certain unnecessary carveouts given the definition of Indebtedness in this sample indenture.

[4]This concept is usually embedded within the definition of Consolidated Coverage Ratio. In the interest of brevity, that definition (and its associated definitions) has been omitted.

[5]Debt incurred under the Coverage Ratio Exception is generally referred to as "Ratio Debt."

The foregoing paragraph will not prohibit incurrence of the following Indebtedness (collectively, "Permitted Indebtedness")[6]:

(1) the Notes (and the Guarantees thereof) *issued on the Issue Date*[7];

(2) Indebtedness of Issuer or any Restricted Subsidiary to the extent outstanding on the Issue Date (other than Indebtedness under the Credit Facility);

(3) Indebtedness of Issuer or any Restricted Subsidiary under the *Credit Facility*[8] in an aggregate amount *at any time outstanding*[9] pursuant to this clause (3) (including amounts outstanding on the date of the Indenture) not to exceed the greater of

- $[____][10] million; and
- the sum of (x) 70% of the net book value of the inventory of Issuer and the Restricted Subsidiaries and (y) 85% of the net book value of the accounts receivable of Issuer and the Restricted Subsidiaries, in each case

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[6]Note that the general rule under any indenture is that any action that is not prohibited is permitted. You don't need specific permission to take action unless it is restricted elsewhere. Finally, you only need one exception. To the extent one of the following baskets prohibits an action, that action is only prohibited for purposes of that basket, not all baskets. Another basket may very well permit the action as each provision is generally deemed to have "independent legal significance" under applicable law.

[7]Note that to the extent the indenture permits "Additional Notes" that the addition of this clause means that the issuer will need to find another exception permitting the issuance of that debt.

[8]The definition of Credit Facility should allow for refinancing.

[9]Watch for language like this allowing debt outstanding "at any time." This means the basket is refillable. Without that language, it could be argued that the basket fills once and then is gone forever.

[10]This should be equal to or greater than the current credit facility to permit flexibility for increasing the size of the facility.

determined on a consolidated basis in accordance with GAAP[11];

(4) Refinancing Indebtedness (including the Exchange Notes and the related Guarantees) of Indebtedness incurred under the Coverage Ratio Exception, clause (1) of this paragraph, clause (2) of this paragraph (other than any Indebtedness owed to Issuer or any of its Subsidiaries)[12] or this clause (4)[13];

(5) Indebtedness owed by Issuer or any Restricted Subsidiary to Issuer or any Restricted Subsidiary[14]; provided that

- any such Indebtedness owed by Issuer shall be expressly subordinated to the prior payment in full in cash of all Obligations with respect to the Notes, and any such Indebtedness owed by any Guarantor (other than to Issuer or any other Guarantor) shall be subordinated by

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[11]There is not always a borrowing base concept in the indenture, but it's a good idea if the Issuer is using a borrowing base concept in its Credit Facility. It allows the credit agreement to grow with the company. The borrowing base should be equal to or greater than the borrowing base under the Credit Facility.

[12]Not surprisingly, this prohibits Issuer from refinancing intercompany debt with third party debt.

[13]Note that, in this form, Refinancing Indebtedness is covered on an individual basis in the various baskets as appropriate. Other forms would require you to delineate which baskets you can refinance in one place or just permit refinancing generally.

[14]High yield indentures create a sort of self-contained "ecosystem." Setting structural subordination issues aside, any capital flows within the system (which does not include Parent if it is not the Issuer or a Guarantor), whether loans, capital contributions, repayment of loans or dividends, should be permitted. The documentation of these intercompany capital flows should not be overlooked, as it can be critically important in a debt restructuring or bankruptcy. If capital flows intended to be intercompany debt are not adequately documented with a promissory note specifying interest, maturity and other typical provisions, the transfer of funds may be recast as an equity contribution or dividend and this can affect recoveries of the creditors at various levels of the corporate structure.

its terms to the prior payment in full in cash of all Obligations with respect to the Guarantee of such Guarantor; and

- *if such Indebtedness is held by a Person other than Issuer or any Restricted Subsidiary, Issuer or such Restricted Subsidiary shall be deemed to have incurred Indebtedness not permitted by this clause (5)*[15];

(6) (x) the guarantee by Issuer or any Guarantor of Indebtedness of Issuer or a Guarantor and (y) the guarantee by any Restricted Subsidiary that is not a Guarantor of Indebtedness of any other Restricted Subsidiary that is not a Guarantor; provided that, in each case, the Indebtedness being guaranteed is incurred pursuant to the Coverage Ratio Exception or another clause in this paragraph;

(7) Hedging Obligations entered into in the ordinary course of business and not for speculative purposes[16];

(8) industrial revenue bonds or similar tax-exempt Indebtedness, Purchase Money Indebtedness and Capital Lease Obligations of Issuer or any Restricted Subsidiary incurred to finance the acquisition, construction or improvement of any assets (including capital expenditures of Issuer or any Restricted Subsidiary), and Refinancings thereof, in an aggregate

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[15]This prohibits selling intercompany debt to a third party.

[16]This concept often comes with the following restriction: "provided, however, that, in the case of Currency Agreements and Interest Rate Agreements, such Currency Agreements and Interest Rate Agreements do not increase the Indebtedness of Issuer outstanding at any time other than as a result of fluctuations in foreign currency exchange rates or interest rates or by reason of fees, indemnities and compensation payable thereunder." You should resist this language as no one seems to know exactly what it means and at worst it can be read as an exception that swallows the rule because hedging arrangements are virtually always affected by fluctuations in foreign currency exchange rates, interest rates, fees, indemnities and compensation payable thereunder.

amount not to exceed $[__] million at any time outstanding[17];

(9) Indebtedness of any Foreign Subsidiary in an aggregate amount not to exceed $[___] million at any time outstanding[18];

(10) Indebtedness of Issuer or any Restricted Subsidiary (including letters of credit) in order to provide security for workers' compensation claims, payment obligations in connection with self-insurance, or similar requirements of Issuer or any Restricted Subsidiary in the ordinary course of business;

(11) *customary*[19] indemnification, adjustment of purchase price or similar obligations, including title insurance, of Issuer or any Restricted Subsidiary, in each case, incurred in connection with the *acquisition*[20] or disposition of any assets of Issuer or

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[17] In some indentures, there is an even broader exception for any Indebtedness incurred to finance the acquisition of tangible assets used in the business, regardless of whether such Indebtedness is secured by such assets, as would be the case in formal purchase money indebtedness. This broader exception is obviously a very pro-issuer provision but does necessitate clear and accurate tracking of funds to establish how the Indebtedness proceeds were actually used.

[18] This basket is designed to permit third party debt at the Foreign Subsidiary level. Note, that in this form, non-Guarantors are not permitted to incur Ratio Debt and thus this carveout is essential. In addition to intercompany advances, many Foreign Subsidiaries will incur local currency debt as a natural hedge and to maintain a local banking relationship. Note also the "at any time outstanding" language, making this carveout essentially a revolver.

[19] The modifier "customary," which is used in a number of places in many indentures, should not be accepted without resistance because it is best to avoid having to argue at some future date whether the relevant provisions are in fact customary.

[20]This basket typically only permits this type of debt in connection with dispositions, on the theory that purchase price adjustments are in fact an obligation akin to debt, and that if the seller hadn't in effect extended credit to

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any Restricted Subsidiary (other than guarantees of Indebtedness incurred by any Person acquiring all or any portion of such assets for the purpose of financing such acquisition);

(12) obligations of Issuer or any Restricted Subsidiary in respect of performance bonds and completion, guarantee, surety and similar bonds in the ordinary course of business;

(13) Indebtedness arising from the honoring by a bank or other financial institution of a check, draft or similar instrument inadvertently (except in the case of daylight overdrafts) drawn against insufficient funds; provided, however, that such Indebtedness is extinguished within five business days of incurrence;

(14) Indebtedness arising in connection with endorsement of instruments for deposit in the ordinary course of business;

(15) Indebtedness evidenced by promissory notes subordinated to the Notes and the Guarantees issued to current or former employees or directors of Issuer or any Subsidiary (or their respective spouses or estates) in lieu of cash payments for Capital Stock being repurchased from such Persons[21];

(16) Indebtedness consisting of take-or-pay obligations contained in supply agreements entered into in the ordinary course of business[22];

(17) Subordinated indebtedness in an aggregate amount not to exceed $[___] million at any time outstanding; and

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the issuer on these matters, the issuer would have had to obtain it elsewhere. That analysis, of course, does not apply the indemnification point, which is a far different proposition for a buyer than a seller.

[21]This carveout can be essential for a company that has retained a repurchase right on management equity.

[22]This is an example of a carveout that is arguably unnecessary in light of the definition of Indebtedness.

(18) additional Indebtedness of Issuer or any Restricted Subsidiary in an aggregate amount not to exceed $[___][23] million at any time outstanding.

For purposes of determining compliance with this covenant, in the event that an item of Indebtedness meets the criteria of more than one of the categories of Permitted Indebtedness described in clauses (1) through (18) above or is entitled to be incurred pursuant to the Coverage Ratio Exception, Issuer shall, in its sole discretion, classify such item of Indebtedness and may divide and classify such Indebtedness in more than one of the types of Indebtedness described (except that Indebtedness outstanding under the Credit Facility on the Issue Date shall be deemed to have been incurred under clause (3) above) and may later reclassify such item *under the Coverage Ratio Exception*[24] or any one or more of the categories of Permitted Indebtedness described in clauses (3) through (18) above (provided that at the time of reclassification it meets the criteria in such category or categories). The maximum amount of Indebtedness that Issuer or any Restricted Subsidiary may incur pursuant to this covenant will not be deemed to be exceeded solely as the result of fluctuations in the exchange rates of currencies.[25] In determining the

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[23]This "hell or high water" basket is the most useful basket of all. Some bankers, in a moment of uncharacteristic candor, might tell you that bond buyers will simply add up all the baskets, without regard for their likelihood of use. If that is the view, then the company is better off foregoing the specific baskets in favor of this general basket. Other bankers might tell you that this basket, correctly, receives more attention than the others due to its inherent flexibility and that a better strategy is to rely on numerous, hard-to-quantify baskets while keeping the hell or high water basket to a reasonable level.

[24]The ability to classify and reclassify debt is useful flexibility for Issuer. In particular, the ability to reclassify Basket Debt as Ratio Debt allows Issuer to take advantage of its coverage without needing to refinance existing debt, which may be at attractive rates or terms. Note that even without that ability, Issuer would clearly be able to refinance by issuing new Ratio Debt, but would incur the expense of that refinancing.

[25]This language appears frequently, yet makes no sense. The debt covenant is an incurrence test. Debt, once incurred, cannot violate the covenant, and so fluctuations in debt after its incurrence cannot violate the covenant.

amount of Indebtedness outstanding under one of the clauses above, the outstanding principal amount of any particular Indebtedness of any Person shall be counted only once and any obligation of such Person or any other Person arising under any guarantee, Lien, letter of credit or similar instrument supporting such Indebtedness shall be disregarded so long as it is permitted to be incurred by the Person or Persons incurring such obligation.

Relevant Definitions

"Indebtedness" means, with respect to any Person, without duplication, and whether or not contingent:

(1) all indebtedness of such Person *for borrowed money*[26] or *for the deferred purchase price of assets or services*[27] or which is evidenced by a note, bond, debenture or similar instrument, to the extent it would appear as a liability upon a balance sheet of such Person prepared in accordance with GAAP;

(2) all Capital Lease Obligations of such Person;

(3) all obligations of such Person in respect of letters of credit or bankers' acceptances issued or created for the account of such Person;

(4) net obligations of such Person under Interest Rate Agreements or Currency Agreements;

(5) all Disqualified Stock issued by such Person and *all preferred stock issued by any Subsidiary of such Person,*[28] in

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[26]Other formulations defining Indebtedness do not limit it to "borrowed money." When not so limited, it puts additional pressure on the carveouts for Permitted Indebtedness.

[27]Compare this concept to the fifth and sixth bullets under the next paragraph.

[28]Preferred stock of a subsidiary is a concern because of potential structural subordination, whereby the holders of the preferred stock would have a senior claim to the high yield debt holders whose claim on the subsidiary may be only through its common stock.

each case, valued at the greater of its voluntary or involuntary maximum fixed repurchase price *plus accrued and unpaid dividends thereon*[29];

(6) to the extent not otherwise included, *any guarantee by such Person of any other Person's indebtedness*[30] or other obligations described in clauses (1) through (5) above; and

(7) all Indebtedness of others secured by a Lien on any asset of such Person, whether or not such Indebtedness is assumed by such Person; provided, however, that the amount of such Indebtedness shall be the lesser of (x) the Fair Market Value of such asset at such date of determination and (y) the amount of such Indebtedness.

For the avoidance of doubt, "Indebtedness" of any Person shall not include[31]:

- current trade payables incurred in the ordinary course of business and payable in accordance with customary practices;
- deferred tax obligations;
- minority interest;
- *uncapitalized* interest[32];

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[29]Because the indebtedness covenant is an incurrence test, the only time this language is relevant is when the amount of debt outstanding is tested, for example, under the general Permitted Debt basket.

[30]But see clause (6) of Permitted Debt.

[31]This language is obviously helpful, but technically superfluous. To the extent the definition of Indebtedness is not limited by the "borrowed money" concept, these concepts should be included in the definition of Permitted Indebtedness.

[32]The accrual of interest should never be considered an incurrence of Indebtedness — if it were, then Issuer would be constantly incurring new debt, and therefore being required to run through the Incurrence of Indebtedness covenant. This formulation raises the possibility that the accretion of capitalized interest would be an incurrence. The question left unanswered is when that incurrence would occur. Note also the tension between this concept and the

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- noninterest bearing installment obligations and accrued liabilities incurred in the ordinary course of business; and
- obligations of Issuer or any Restricted Subsidiary pursuant to contracts for, or options, puts or similar arrangements relating to, the purchase of raw materials or the sale of inventory at a time in the future entered into in the ordinary course of business.

For purposes hereof, the "maximum fixed repurchase price" of any Disqualified Stock that does not have a fixed repurchase price shall be calculated in accordance with the terms of such Disqualified Stock as if such Disqualified Stock were purchased on any date on which Indebtedness shall be required to be determined pursuant to the Indenture, and if such price is based on, or measured by the Fair Market Value of, such Disqualified Stock, such Fair Market Value is to be determined in good faith by the board of directors of the issuer of such Disqualified Stock. The amount of Indebtedness of any Person at any date shall be the outstanding balance at such date of all unconditional obligations as described above and the maximum liability, upon the occurrence of the contingency giving rise to the obligation, of any contingent obligations as described above at such date; provided, however, that the amount outstanding at any time of any Indebtedness issued with original issue discount shall be deemed to be the face amount of such Indebtedness less the remaining unamortized portion of the original issue discount of such Indebtedness at such time as determined in conformity with GAAP.

"Disqualified Stock" means, with respect to any Person, any Capital Stock which by its terms (or by the terms of any security into which it is convertible or for which it is exchangeable) or upon the happening of any event:

(1) matures or is mandatorily redeemable pursuant to a sinking fund obligation or otherwise; or

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treatment of accrued dividends under clause (5) of the definition of Indebtedness.

(2) is redeemable at the option of the holder thereof, in whole or in part, in each case on or prior to the date that is *91 days*[33] after the Stated Maturity of the Notes;

provided that any class of Capital Stock of such Person that, by its terms, authorizes such Person to satisfy in full its obligations with respect to the payment of dividends or upon maturity, redemption (pursuant to a sinking fund or otherwise) or repurchase thereof or otherwise by the delivery of Qualified Stock, and that is not convertible, puttable or exchangeable for Disqualified Stock or Indebtedness, will not be deemed to be Disqualified Stock so long as such Person satisfies its obligations with respect thereto solely by the delivery of Qualified Stock; provided further that any Capital Stock that would not constitute Disqualified Stock but for provisions thereof giving holders thereof (or the holders of any security into or for which such Capital Stock is convertible, exchangeable or exercisable) the right to require Issuer or any Restricted Subsidiary to redeem or purchase such Capital Stock upon the occurrence of a change in control occurring prior to the final maturity date of the Notes shall not constitute Disqualified Stock if such Capital Stock specifically provides that Issuer or such Restricted Subsidiary will not redeem or purchase any such Capital Stock pursuant to such provisions prior to Issuer's purchase of the Notes as required pursuant to the provisions described under the caption "— Change of Control."[34]

"Pro Forma Cost Savings" means, with respect to any period, the reduction in costs that occurred during the period that were (1) directly attributable to an acquisition and calculated on a basis that is consistent with Article 11 of Regulation S-X under the Securities Act as in effect on the date of the Indenture or *(2) implemented by the business that was the subject of any such acquisition within one year of the date of the*

[33]Due to the 90-day bankruptcy preference rule.

[34]This provision will often contain the following additional qualification ". . . and the change in control provisions applicable to such Capital Stock are no more favorable to such holders than the provisions described under the caption '— Change of Control'. . . ." This language is inappropriate because, to the extent the Disqualified Stock is not paid out until after the bonds, the bondholders should not care what the Disqualified Stock gets.

acquisition and that are supportable and quantifiable by the underlying accounting records of such business,[35] as if, in the case of each of clauses (1) and (2), all such reductions in costs had been effected as of the beginning of such period, decreased by any incremental expenses (except to the extent capitalized on Issuer's consolidated balance sheet) incurred or to be incurred for the period in order to achieve such reduction in costs.

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[35]Clause (2) goes well beyond Article 11 of Regulation S-X and thus is highly desirable for the Issuer.

RESTRICTED PAYMENTS COVENANT

<u>Limitation on Restricted Payments</u>

Issuer[36] will not, and will not permit any *Restricted Subsidiary*[37] to, directly or indirectly, declare or make a Restricted Payment if:

(1) a Default has occurred and is continuing or would result therefrom;

(2) *Issuer could not incur at least $1.00 of additional Indebtedness pursuant to the Coverage Ratio Exception*[38]; *or*

(3) the aggregate amount of such Restricted Payment together with all other Restricted Payments (the amount of any Restricted Payments made in assets other than cash to be valued at their Fair Market Value) declared or made since the Issue Date (other than any Restricted Payment described in clause (2), (3), (4), (5), (6), (7), (8), (9) or (10)[39] of the next paragraph) would exceed the sum (the "Basket") of:

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[36] Because Parent is outside the "system" in this form, this covenant prohibits Issuer from paying a dividend upstream to Parent and thereby depriving the Issuer's creditors of such asset unless the dividend is a "Permitted Restricted Payment."

[37]As always, watch for the parties. Without an exception or a narrowly tailored definition of Restricted Payment (which is contained in this form), the inclusion of Restricted Subsidiaries here would prevent the Restricted Subsidiaries from paying dividends upstream to Issuer.

[38]Note that no Restricted Payments may be made unless the Issuer is at or above the Coverage Ratio Exception, even if there is otherwise room in the Restricted Payment Basket. Thus, it is important that "Permitted Restricted Payments" not be subject to the Coverage Ratio Exception, or the company will be completely prohibited from making any Restricted Payments unless and until it achieves compliance with the Coverage Ratio Exception.

[39]Consider which "Permitted Restricted Payments" should be counted against the Basket. There are two reasons to include a payment in "Permitted Restricted Payments": (1) so it can be made at any time, irrespective of earnings or ratio

(Continued…)

(a) 50% of the Consolidated Net Income accrued during the period (treated as one accounting period) from the *beginning*[40] of the current fiscal quarter to the end of the most recent fiscal quarter prior to the date of such Restricted Payment for which internal financial statements are available *(or, in case such Consolidated Net Income shall be a deficit, minus 100% of such deficit)*[41]; plus

(b) the aggregate Net Cash Proceeds received by Issuer from the issuance and sale (other than to a Subsidiary of Issuer) of Qualified Stock subsequent to the Issue Date[42]; plus

(c) the amount by which Indebtedness or Disqualified Stock incurred or issued subsequent to the Issue Date is reduced on Issuer's consolidated balance sheet upon the conversion or exchange (other than by a Subsidiary of Issuer) into Qualified Stock (less the amount of any cash, or the Fair Market Value of any other asset, distributed by Issuer or any Restricted Subsidiary upon such conversion or exchange); provided that such amount shall not exceed the aggregate Net Cash Proceeds received by

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compliance; and (2) because it is "ordinary course" and thus should not even count against the Basket.

[40]The standard language here starts the earnings period at the end of the most recent fiscal quarter. An issuer may prefer to start the earnings period at the beginning of that quarter, depending on whether the quarter in question is profitable, which you will likely know when negotiating the indenture.

[41]As inequitable as this provision seems, it is entirely standard under the theory that a company should make no Restricted Payments, at least under this one clause, if does not have positive net income.

[42]The idea here is that, to the extent new equity has come in, that same money should be able to go back out without detriment to the bondholders.

Issuer or any Restricted Subsidiary from the issuance and sale (other than to a Subsidiary of Issuer) of such Indebtedness or Disqualified Stock[43]; plus

(d) to the extent not included in the calculation of the Consolidated Net Income referred to in (a), an amount equal to, without duplication[44]:

- 100% of 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 (other than a Permitted Investment) made by Issuer or any Restricted Subsidiary since the Issue Date; plus
- the net reduction in Investments (other than Permitted Investments) in any Person resulting from dividends, repayments of loans or advances or other Transfers of assets subsequent to the Issue Date, in each case to Issuer or any Restricted Subsidiary from such Person; plus
- to the extent that the 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

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[43]This addresses the same issue as the prior exception, but it contemplates the Issuer using equity proceeds to reduce competing debt or preferred stock. In either case, the Issuer is deleveraging its balance sheet and should therefore be allowed to make a corresponding amount of Restricted Payments.

[44]The following provisions allow the company to take advantage of some returns on its Investments in refilling the Basket.

liquidated or merged into, a Restricted Subsidiary;

provided that the foregoing shall not exceed, in the aggregate, the amount of all Investments which previously reduced the Basket.[45]

The provisions of the foregoing paragraph shall not prohibit the following[46]:

(1) dividends paid within 90 days after the date of declaration thereof if at such date of declaration such dividend would have been permitted under the Indenture[47];

(2) any repurchase, redemption, retirement or other acquisition of Capital Stock or Subordinated Obligations made in exchange for, or out of the proceeds of the substantially concurrent issuance and sale (other than to a Subsidiary of Issuer) of, Qualified Stock or, with respect to any such Subordinated Obligations, in exchange for or out of the proceeds of the substantially concurrent incurrence and sale (other than to a Subsidiary of Issuer) of Refinancing Indebtedness thereof; provided that (x) *no such exchange or issuance and sale shall increase the Basket*[48] and (y) no

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[45]This proviso is typical in the sense that it limits refilling the Basket to amounts that had previously reduced the Basket. Typically, the limitation applies on an Investment-by-Investment basis. In this version, there is a "portfolio" concept, allowing the Issuer to balance winners against losers. Assuming the Issuer will sell the winners and keep or close the losers, this provision will allow the basket to refill quicker than would otherwise be the case.

[46]The following are items that this annotation refers to as "Permitted Restricted Payments." There is not typically a defined term for this concept.

[47] This exception simply recognizes the practical problem of having to set a record date in advance of a dividend payment date. Once the Issuer declares the dividend and the associated record date, it cannot as a practical matter, cancel it. Thus, compliance with the Indenture is tested as of the declaration date.

[48]This is a good example of a payment that should be permitted, but should not increase the Basket. A transaction as described is essentially a swap and while it

(Continued…)

Default has occurred and is continuing or would occur as a consequence thereof;

(3) the purchase, redemption, acquisition, cancellation or other retirement for a nominal value per right of any rights granted to all the holders of Common Stock of Parent pursuant to any shareholders' rights plan adopted for the purpose of protecting shareholders from unfair takeover tactics; provided that any such purchase, redemption, acquisition, cancellation or other retirement of such rights shall not be for the purpose of evading the limitations of this covenant (all as determined in good faith by the Board of Directors)[49];

(4) payments by Issuer or any Restricted Subsidiary in respect of Indebtedness of Issuer or any Restricted Subsidiary owed to Issuer or another Restricted Subsidiary[50];

(5) repurchases of Capital Stock deemed to occur upon the exercise of stock options or warrants if such Capital Stock represents a portion of the exercise price thereof *and repurchases of Capital Stock deemed to occur upon the withholding of a portion of the Capital Stock granted or*

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should not prejudice bondholders, it should also not give the company additional room in the Basket.

[49] This exception is to permit the Issuer to "pull" its "poison pill" or shareholder rights plan by redeeming or otherwise canceling the rights for nominal value. While the amount is nominal, the Issuer should have this separate exception if it has or may in the future adopt a shareholder rights plan because the Indenture should not be allowed to interfere with the operation of such a plan as it does not affect the bondholders in any direct way.

[50] Within the "system" there should be a robust ability to make, incur and repay intercompany loans. Note there may be structural subordination concerns and, therefore, this ability may not be without controversy. Also, note that Parent is not within the "system" in this form.

awarded to an employee to pay for the taxes payable by such employee upon such grant or award[51];

(6) if no Default has occurred and is continuing or would occur as a consequence thereof, the declaration and payment of dividends to holders of any class or series of Designated Preferred Stock (other than Disqualified Stock) issued after the Issue Date; provided that, at the time of the issuance of such Designated Preferred Stock and after giving pro forma effect thereto, Issuer could incur at least $1.00 of additional Indebtedness pursuant to the Coverage Ratio Exception[52];

(7) purchases of the Capital Stock, or contributions to the equity, of any Foreign Subsidiary to the extent that Investments in the form of Indebtedness advanced to such Foreign Subsidiary would, or are likely to, result in (x) any then existing Indebtedness owing by such Foreign Subsidiary to Issuer or any Restricted Subsidiary being characterized as equity under the "thin capitalization" rules of the U.S. Internal Revenue Code or under any other applicable law or (y) any similar consequences[53];

(8) the payment of dividends, other distributions, loans, advances or other amounts by Issuer to its direct or indirect parent to pay corporate overhead incurred in the ordinary

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[51]The carveout for "cashless exercises" should not be controversial. The carveout for withholding may be, given that the company will have to turn that money over to the IRS, and thus it reflects an actual cash outflow.

[52]Note that this provision is subject to the no default condition and the coverage ratio test. If both of these conditions are satisfied, the form Indenture permits dividends on typical preferred stock.

[53]This is the weak form of this provision, allowing Investments in Foreign Subsidiaries (which are not Guarantors) only to the extent required for "thin cap" rules. Ideally, all Investments in Foreign Subsidiaries would be allowed but this of course represents an economic detriment to the bondholders because they have not claim to the assets of the Foreign Subsidiaries other than an indirect claim through the equity interest.

course of business, up to an aggregate under this clause (8) of $[_____] per fiscal year plus any bona fide indemnification claims made by directors or officers of Parent[54];

(9) the declaration and payment of dividends to, or the making of loans in amounts required for such party to pay:

(a) franchise taxes and other fees, taxes and expenses required to maintain its corporate existence; and

(b) federal, state and local income taxes, to the extent such income taxes are attributable to the income of Parent; provided, however, that in each case the amount of such payments in any fiscal year do not exceed the amount that Parent would be required to pay in respect of federal, state and local taxes for such fiscal period were Parent to pay such taxes as a stand-alone taxpayer; and

(10) Restricted Payments of up to $[___][55] million in the aggregate *since the Issue Date.*[56]

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[54] Clauses (8) and (9) permit Issuer to upstream cash to Parent for specified permitted uses such as the payment of franchise taxes and other expenses associated with the Parent's continued existence of function as a holding company.

[55]There is no principle on which this number is based and many factors are relevant to the discussion of the appropriate number, including the company's cash on hand at the time the notes are being issued under the indenture, its business plan and its associated liquidity and capital expenditure needs. Repeat issuers will often look to the total amount available (including under the Basket) under their other indentures and seek a number at least equal to that amount so that they do not establish a lower floor under the new indenture.

[56]Note that this is a one-time use basket; however, see the definition of "Permitted Investment" for a limited ability to refill this basket.

Relevant Definitions

"Investment" in any Person means any direct or indirect advance, loan or other extension of credit (including by way of guarantee or similar arrangement) or capital contribution to, or any purchase or acquisition of Capital Stock, Indebtedness or other similar instruments issued by, such Person. "Investment" excludes (a) any Restricted Payment of the type described in clause (2) of the definition "Restricted Payment" and (b) any purchase or acquisition of Indebtedness of Issuer or any of its Subsidiaries.[57]

For purposes of the definition of "Unrestricted Subsidiary," the definition of "Restricted Payment" and the covenant described under "— Certain Covenants — Limitation on Restricted Payments":

(1) "Investment" shall include the portion (proportionate to Issuer's direct and indirect equity interest in such Subsidiary) of the Fair Market Value of the net assets of any Restricted Subsidiary at the time that such Restricted Subsidiary is designated an Unrestricted Subsidiary[58];

(2) any assets Transferred to or from an Unrestricted Subsidiary shall be valued at their Fair Market Value at the time of such Transfer; and

(3) if Issuer or any Restricted Subsidiary Transfers any Capital Stock of any direct or indirect Restricted Subsidiary, or any Restricted Subsidiary issues Capital Stock, such that, after giving effect to any such Transfer or issuance, such Person is no longer a Restricted Subsidiary, Issuer shall be deemed to have made an Investment on the date of any such Transfer or

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[57]Note this language means that transfers of intercompany debt other than transfers of intercompany debt of Parent will not be treated as an Investment.

[58]This provision treats the designation of an Unrestricted Subsidiary as if it were an investment in new entity. That is consistent with the notion of Unrestricted Subsidiaries being "outside of the system," *i.e.,* essentially a third party (except, of course, for purposes of the Affiliate Transaction covenant). It is the logical counterpoint to clause (4) of the definition of Permitted Investment, where Investments in a person that becomes a Guarantor are permitted.

issuance equal to the Fair Market Value of the Capital Stock of such Person held by Issuer or such Restricted Subsidiary immediately following any such Transfer or issuance.[59]

"Permitted Investment" means:

(1) any Investment in Temporary Cash Investments or the Notes or the Exchange Notes;

(2) any Investment in Issuer or any Guarantor[60];

(3) Investments existing on the Issue Date and any amendment, modification, restatement, supplement, extension, renewal, refunding, replacement or refinancing, in whole or in part, thereof[61];

(4) any Investment by Issuer or any Restricted Subsidiary in a Person, if as a result of such Investment[62]:

- such Person becomes a Guarantor; or
- such Person is merged or consolidated with or into, or Transfers or conveys all or substantially all of its assets to, or is liquidated into, Issuer or a Guarantor;

(5) any Investment by any Foreign Subsidiary in[63]:

[59]This provision is another logical corollary of the provision at note 46, again predicated on the idea that once a Subsidiary goes out of the system, the value in that subsidiary should be treated as an investment.

[60]Again, allowing intercompany debt within the "system."

[61]This carveout can be very important for roll-up companies, who may need to restructure their acquisitions from time to time.

[62]This is the provision that permits a company to do acquisitions, so long as the acquired entity becomes a Guarantor.

[63]This is a parallel provision to the one at note 49. Foreign Subsidiaries, which are not Guarantors, live in their own "system," generally entitled to do within their system that which members of the main domestic system can do within that system.

- any other Foreign Subsidiary; or
- any Person, if as a result of such Investment, (x) such Person becomes a Foreign Subsidiary, or (y) such Person is merged or consolidated with or into, or Transfers or conveys all or substantially all of its assets to, or is liquidated into, any Foreign Subsidiary;

(6) receivables owing to Issuer or any Restricted Subsidiary if created or acquired in the ordinary course of business and payable or dischargeable in accordance with customary trade terms; provided that such trade terms may include such concessionary trade terms as Issuer or any such Restricted Subsidiary deems reasonable under the circumstances[64];

(7) loans or advances to employees of Issuer or any Restricted Subsidiary that are made in the ordinary course of business consistent with past practices of Issuer or such Restricted Subsidiary[65];

(8) Investments in any Person to the extent such Investment represents the noncash portion of the consideration received in an Asset Sale or Sale of a Principal Property as permitted pursuant to the covenant described under "— Certain Covenants — Limitation on Asset Sales" or "— Certain Covenants — Limitation on Sale of Principal Properties"[66];

(9) Investments in securities of trade creditors or customers received pursuant to any plan of reorganization or similar

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[64]This language clarifies that, while a loan to a third party is an Investment, ordinary trade receivables are not. This concept could also be handled by excluding such activities from the definition of Investment.

[65]This language is often qualified by a basket. Whether a basket is a better approach than the reference to ordinary course of business depends on Issuer's ordinary course of business.

[66]This provision gives Issuer the ability to take securities in partial payment for divestitures. Without it, the (typically) 25% stub available under the Asset Sale covenant would be largely meaningless.

arrangement upon the bankruptcy or insolvency of such trade creditors or customers[67];

(10) Hedging Obligations incurred pursuant to clause (7) of the definition of “Permitted Indebtedness”;

(11) Investments in joint ventures not to exceed the greater of $[__] million or [__]% of total assets at any time outstanding; provided that each such joint venture is engaged only in a Permitted Business[68];

(12) Investments in Unrestricted Subsidiaries not to exceed the greater of $[__] million or [__]% of total assets at any time outstanding[69];

(13) any Investment by Issuer or a wholly owned Subsidiary of Issuer in a Securitization Entity; provided that such Investment is in the form of a Purchase Money Note or an

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[67]A creditor in a bankruptcy is often unable to prevent the issuance of such securities to it — it would be adding injury to insult if such an event were to create a default under Issuer’s indenture.

[68] This fundamentally represents a general exception for investments in entities that are not Subsidiaries (whether Foreign, Restricted or Unrestricted), as there is technically no such thing as a “joint venture” from a legal perspective. While this formulation is fairly typical, an Issuer may want to eliminate the “joint venture” language, as it may be unduly restrictive if you plan to make minority investments in various entities. The Permitted Business restriction is also an important limitation and should be defined carefully.

[69]This can be a critically important exception because Issuer may need, for various reasons, to designate a subsidiary as an Unrestricted Subsidiary. It may, for example, want to operate a line of business that is financed with other resources and not subject to the restrictions of the Indenture. Without room in the Basket or a carveout, the establishment of the vehicle for doing this might not be possible.

equity interest or interests in accounts receivable generated by Issuer or any of its Subsidiaries[70];

(14) any Indebtedness of Issuer to any of its Subsidiaries incurred in connection with the purchase of accounts receivable and related assets by Issuer from any such Subsidiary which assets are subsequently conveyed by Issuer to a Securitization Entity in a Qualified Securitization Transaction; or

(15) any guarantees of Indebtedness permitted by clause (6) or (17) of the definition of "Permitted Indebtedness"; additional Investments in an aggregate amount not to exceed $[___] million at any time outstanding.

The amount of any Investments outstanding for purposes of clause (11), (12) or (15) above or for purposes of clause (8) of covenant described under "— Certain Covenants — Limitation on Restricted Payments" shall be equal to the aggregate amount of Investments made pursuant to such clause reduced (but not below zero) by the following (to the extent not included in the calculation of Consolidated Net Income for purposes of determining the Basket and without duplication)[71]:

- 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 such clause;
- the net reduction in Investments made pursuant to such clause resulting from dividends, repayments of loans or advances or other Transfers of assets to Issuer or any Restricted Subsidiary;

[70] This is one of a number of provisions that allow Issuer to set up a securitization vehicle. These provisions are collected at the back of this document under the caption "Securitization Riders."

[71] This is a helpful, but not common, clarifying provision that gives effect to what should otherwise be the common-sense conclusion that an investment is no longer outstanding if Issuer has received its money back.

- to the extent that the amount available for Investments under such clause was reduced as the result of the designation of an Unrestricted Subsidiary, the portion (proportionate to Issuer's equity interest in such Subsidiary) of the Fair Market Value of the net assets of such Unrestricted Subsidiary at the time such Unrestricted Subsidiary is redesignated, or liquidated or merged into, a Restricted Subsidiary; and
- the net reduction in Investments made pursuant to such clause to resulting from repayment of letters of credit or the expiration of letters of credit undrawn.

"Restricted Payment" means, with respect to any Person:

(1) any dividend or other distribution declared or paid on any Capital Stock of Issuer (other than dividends or distributions payable solely in Qualified Stock)[72];

(2) any payment to purchase, redeem or otherwise acquire or retire for value any Capital Stock of Issuer or any Affiliate of Issuer (other than any Restricted Subsidiary);

(3) any payment to purchase, redeem, defease or otherwise acquire or retire for value any Subordinated Obligations *prior to the 91 days before the Stated Maturity thereof*[73] (other than any Purchase Money Indebtedness incurred after the Issue Date upon the sale of the related asset); or

(4) the making of an Investment (other than a Permitted Investment), including any Investment in an Unrestricted Subsidiary (including by the designation of any Subsidiary of Issuer as an Unrestricted Subsidiary).

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[72]Note that, in this case, only dividends by Issuer are Restricted Payments. Dividends within the system (which does not include Parent) should not be prohibited.

[73]Note that scheduled repayments of subordinated obligations generally are not prohibited, only repayments before their stated maturity. It is nice to get some grace period (here, 91 days) to allow flexibility.

LIENS COVENANT

Limitation on Liens

Issuer will not, and will not permit any Restricted Subsidiary to, directly or indirectly, incur any Lien (other than Permitted Liens) of any kind on any asset of Issuer or any Restricted Subsidiary (including Capital Stock of a Restricted Subsidiary), whether owned at the Issue Date or thereafter acquired, or any income or profits therefrom or assign or convey any right to receive income therefrom.

Relevant Definitions

"Permitted Liens" means:

(1) Liens securing obligations under the Credit Agreement;

(2) Liens in favor of Issuer or any Restricted Subsidiary[74];

(3) Liens on assets of a Person at the time such Person becomes a Subsidiary; provided that (x) such Lien was not incurred in anticipation of or in connection with the transaction or series of related transactions pursuant to which such Person became a Subsidiary and (y) such Lien does not extend to or cover any assets of Issuer or any other Restricted Subsidiary[75];

(4) Liens existing on the Issue Date;

(5) Liens imposed by law that are incurred in the ordinary course of business and do not secure Indebtedness for borrowed money, such as carriers', warehousemen's, mechanics', landlords', materialmen's, employees',

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[74] This exception permits intercompany liens from one Restricted Subsidiary for the benefit of another or for the benefit of the Issuer.

[75] Many security agreements provide that liens apply to after-acquired property so this exception can give rise to the need to structure a transaction such that the target company's liens do not apply to the Issuer's or its Restricted Subsidiaries' assets.

laborers', employers', suppliers', banks', repairmen's and other like Liens[76];

(6) Liens for taxes, assessments and governmental charges not yet due or payable or subject to penalties for nonpayment or that are being contested in good faith and that are appropriately reserved for in accordance with GAAP if required by GAAP;

(7) Liens on assets acquired or constructed after the Issue Date securing Purchase Money Indebtedness and Capital Lease Obligations; provided that such Liens shall in no event extend to or cover any assets other such assets acquired or constructed after the Issue Date with the proceeds of such Purchase Money Indebtedness or Capital Lease Obligations;

(8) zoning restrictions, easements, rights-of-way, restrictions on the use of real property, other similar encumbrances on real property incurred in the ordinary course of business and minor irregularities of title to real property that do not individually or in the aggregate materially impair the value or marketability of the real property affected thereby or the occupation, use and enjoyment with the ordinary course of business of Issuer and the Restricted Subsidiaries at such real property;

(9) terminable or short-term leases or permits for occupancy, in each case entered into in the ordinary cause of business, which leases or permits expressly grant to Issuer or any Restricted Subsidiary the right to terminate them at any time on not more than six months' notice and do not individually or in the aggregate interfere with the operation of the business of Issuer or any Restricted Subsidiary or individually or in the aggregate impair the use (for its

[76]This carveout may be qualified as follows: "in each case, for sums not yet due or that are being contested in good faith by appropriate proceedings and that are appropriately reserved for in accordance with GAAP if required by GAAP."

intended purpose) or the value of the property subject thereto;

(10) Liens resulting from operation of law with respect to any judgments, awards or orders to the extent that such judgments, awards or orders do not cause or constitute an Event of Default;

(11) bankers' Liens, rights of setoff and other similar Liens existing solely with respect to cash and cash equivalents on deposit in one or more accounts maintained by Issuer or any Restricted Subsidiary in accordance with the provisions of the Indenture or applicable Security Documents, in each case granted in the ordinary course of business in favor of the bank or banks with which such accounts are maintained, securing amounts owing to such bank with respect to cash management and operating account arrangements; provided that in no case shall any such Liens secure (either directly or indirectly) the repayment of any Indebtedness;

(12) Liens securing Refinancing Indebtedness of the type described in clauses (3) and (7) of this definition; provided that such Liens extend only to the assets securing the Indebtedness being Refinanced;

(13) Liens securing Hedging Obligations of the type described in clause (7) of the definition of "Permitted Indebtedness";

(14) Liens securing Indebtedness of Foreign Subsidiaries;

(15) Liens in favor of any Guarantor;

(16) pledges of or Liens on raw materials or on manufactured products as security for any drafts or bills of exchange drawn in connection with the importation of such raw materials or manufactured products;

(17) Liens in favor of banks that arise under Article 4 of the UCC on items in collection and documents relating thereto and proceeds thereof and Liens arising under Section 2-711 of the UCC;

(18) Liens arising or that may be deemed to arise in favor of a Securitization Entity arising in connection with a Qualified Securitization Transaction;

(19) pledges or deposits by such Person under workers' compensation laws, unemployment insurance laws or similar legislation, or good faith deposits in connection with bids, tenders, contracts (other than for the payment of Indebtedness) or leases to which such Person is a party, or deposits to secure public or statutory obligations of such Person or deposits of cash or United States government bonds to secure surety or appeal bonds to which such Person is a party, or deposits as security for contested taxes or import duties or for the payment of rent or deposits as security for the payment of insurance-related obligations (including, but not limited to, in respect of deductibles, self-insured retention amounts and premiums and adjustments thereto), in each case incurred in the ordinary course of business;

(20) Liens in favor of issuers of surety, performance, judgment, appeal and like bonds or letters of credit issued in the ordinary course of business;

(21) Liens occurring solely by the filing of a UCC statement, which filing has not been consented to by Issuer or any Restricted Subsidiary;

(22) any obligations or duties affecting any property of Issuer or any Restricted Subsidiary to any municipality or public authority with respect to any franchise, grant, license or permit that do not materially impair the use of such property for the purposes for which it is held;

(23) Liens on any property in favor of domestic or foreign governmental bodies to secure partial, progress, advance or other payments pursuant to any contract or statute, not yet due and payable;

(24) Liens encumbering deposits made to secure obligations arising from statutory, regulatory, contractual or warranty requirements;

(25) deposits, pledges or other Liens to secure obligations under purchase or sale agreements; and

(26) other Liens securing obligations in an aggregate amount not to exceed $[__] million at any time outstanding.

AFFILIATE TRANSACTIONS COVENANT

Limitation on Transactions with Affiliates

Issuer will not, and will not permit any Restricted Subsidiary to, directly or indirectly, in one transaction or series of related transactions, Transfer any of its assets to, or purchase any assets from, or enter into any contract, agreement, understanding, loan, advance or guarantee with, or for the benefit of, any Affiliate of Issuer (an "Affiliate Transaction"), unless the terms thereof are no less favorable to Issuer or such Restricted Subsidiary than those that could be obtained at the time of such transaction in arms'-length dealings with a Person that is not such an Affiliate.[77]

A majority of the disinterested members of the Board of Directors must approve each Affiliate Transaction that involves aggregate payments or other assets or services with a Fair Market Value in excess of $[__][78] million. This approval must be evidenced by a board resolution that states that such board members have determined that the transaction complies with the foregoing provisions.

If Issuer or any Restricted Subsidiary enters into an Affiliate Transaction that involves aggregate payments or other assets or services with a Fair Market Value in excess of $[___] million, then prior to the consummation of that Affiliate Transaction, Issuer must obtain a favorable opinion from an Independent Financial Advisor that it has determined such Affiliate Transaction to be fair, from a financial point of view, to the *Holders,*[79] and deliver that opinion to the Trustee.

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[77]Note that all Affiliate Transactions must be on an arms'-length basis, regardless of size.

[78]This amount varies, but it generally in the range of $5–10 million. One helpful data point would be Issuer's general policy regarding board approvals.

[79]This provision often references fairness to Issuer, rather than the Holders. It is unclear what it takes for a transaction to be fair to the Holders, but it is almost certainly a lower threshold than fairness to Issuer because the Holders' interests are those of creditors and, as such, are more narrow that the interest of the Issuer and all of its stakeholders.

The provisions of the *three*[80] foregoing paragraphs will not prohibit the following:

(1) transactions exclusively between or among (x) Issuer and one or more Restricted Subsidiaries or (y) Restricted Subsidiaries; provided, in each case, that no Affiliate of Issuer (other than another Restricted Subsidiary) owns Capital Stock in any such Restricted Subsidiary[81];

(2) *customary*[82] compensation (including bonuses and equity compensation) paid to and other benefits (including retirement, health and other benefit plans) and indemnification arrangements provided on behalf of *directors,*[83] officers and employees of Issuer, any Restricted Subsidiary or direct or indirect parent of Issuer, in each case approved by the Board of Directors;

(3) the entering into of a tax sharing agreement, or payments pursuant thereto, between Parent and/or one or more Subsidiaries, on the one hand, and any other Person with which Parent or such Subsidiaries are required or permitted to file a consolidated tax return or with which Parent or such Subsidiaries are part of a consolidated group for tax purposes, on the other hand, which payments by Parent and the Restricted Subsidiaries are not in excess of the tax

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[80]Note that this language clarifies that none of the tests, even the arms'-length test, apply to the enumerated items.

[81]Again, this type of provision is intended to permit intercompany transactions. Note that this exclusion does not apply to Parent or to any Restricted Subsidiaries in which an Affiliate has an investment in such Restricted Subsidiary's stock.

[82]The word "customary" may be too vague under certain circumstances. This concept is often formulated as "in the ordinary course of business" or "in accordance with past practice." These formulations, however, have the potential to limit the company's ability to respond to market practices that may vary from its own. The phrase "bona fide" would be even better.

[83]Director compensation is often the subject of its own carveout.

liabilities that would have been payable by them on a stand-alone basis;

(4) loans and advances permitted by clause (7) of the definition of "Permitted Investments";

(5) Restricted Payments that are not prohibited by the covenant described under "— Limitation on Restricted Payments";

(6) any transaction with an Affiliate to the extent the transaction involves Qualified Stock[84];

(7) the provision of management, financial and operational services by Issuer and its Subsidiaries to Affiliates of Issuer in which Issuer or any Restricted Subsidiary has an Investment and the payment of compensation for such services; provided that the Board of Directors has determined that the provision of such services is in the best interests of Issuer and the Restricted Subsidiaries[85];

(8) the payment of customary management, consulting, advisory, closing and transaction fees and related expenses to [Equity Sponsor], including, without limitation, in connection with acquisitions, divestitures and financings by Issuer or any Restricted Subsidiary[86];

(9) transactions with suppliers or other purchasers for the sale or purchase of goods which are fair to the Issuer and its Restricted Subsidiaries and, in the judgment of the board of directors, are on terms at least as favorable as might

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[84]These transactions are excluded on the theory that they cannot adversely affect bondholders. This exception, or some version thereof, is particularly important for portfolio companies that may need additional financing in the future, either direct equity or equity kickers in a mezzanine piece.

[85]This provision relates to management services *by* the Issuer, admittedly an unusual phenomenon.

[86]This exception is absolutely critical for private equity and similar funds.

reasonably have been obtained from an unaffiliated third party[87];

(10) issuance of Capital Stock (other than Disqualified Stock) to any Person in connection with a financing transaction;

(11) transactions between Issuer or any Subsidiary and any Securitization Entity in connection with a Qualified Securitization Transaction, in each case provided that such transactions are not otherwise prohibited by the Indenture;

(12) transactions with a Person that is an Affiliate solely because Issuer or any Restricted Subsidiary owns Capital Stock in such Person; provided that no Affiliate of Issuer (other than a Restricted Subsidiary) owns Capital Stock in such Person[88]; or

(13) purchases and sales of raw materials or inventory in the ordinary course of business on market terms.

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[87]This exception can be important for a portfolio company that might like to do business with other portfolio companies of its equity sponsor.

[88]This exception excludes transactions with downstream affiliates on the theory that the company would have no incentive to enter into a transaction that benefits the downstream affiliate at the company's expense.

ASSET SALE COVENANT

Limitation on Asset Sales

Issuer will not, and will not permit any Restricted Subsidiary to, directly or indirectly, consummate any Asset Sale unless:

(a) Issuer or such Restricted Subsidiary receives consideration at the time of such Asset Sale at least equal to the Fair Market Value of the assets included in such Asset Sale; and

(b) at least 75%[89] of the total consideration received in such Asset Sale consists of cash, Temporary Cash Investments or assets (including Capital Stock of any Person) that replace the assets that were the subject of the Asset Sale or in assets (including Capital Stock of any Person) that will be used in the Permitted Business, in each case, valued at the Fair Market Value thereof, or a combination of the foregoing.

For purposes of clause (b) above, the following shall be deemed to be cash:

- the amount (without duplication) of any Indebtedness (other than Subordinated Obligations) of Issuer or such Restricted Subsidiary that is *expressly assumed*[90] by the Transferee in such Asset Sale and with respect to which Issuer or such Restricted Subsidiary, as the case may be, is unconditionally released by the holder of such Indebtedness[91]; and

- the amount of any obligations received from such Transferee that are within 60 days repaid, converted into or sold or otherwise disposed of for cash or Temporary Cash Investments

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[89]This amount typically ranges from 75–85%.

[90]This is the typical formulation; query, however, whether it permits assumption by operation of law, as in a merger.

[91]The assumption of debt by the transferee is deemed to be cash received by the Issuer or a Restricted Subsidiary just as if the Issuer or a Restricted Subsidiary received cash and used it to pay down such debt.

(to the extent of the cash or Temporary Cash Investments actually so received).

If at any time any noncash consideration received by Issuer or any Restricted Subsidiary in connection with any Asset Sale is repaid, converted into or sold or otherwise disposed of for cash or Temporary Cash Investments (other than interest received with respect to any such noncash consideration), then the date of such repayment, conversion, sale or other disposition shall be deemed to constitute the date of an Asset Sale hereunder and the Net Available Proceeds thereof shall be applied in accordance with this covenant.

If Issuer or any Restricted Subsidiary engages in an Asset Sale, Issuer or a Restricted Subsidiary shall, no later than 365 days following the consummation thereof, apply an amount equal to all or any of the Net Available Proceeds therefrom as follows:

(a) to repay borrowings under the Credit Facility;

(b) to redeem, purchase or repay [selected indebtedness][92]; and/or

(c) to make an investment in or expenditure for assets (including Capital Stock of any Person) that replace the assets that were the subject of the Asset Sale or in assets (including Capital Stock of any Person) that will be used in the Permitted Business.

The amount of Net Available Proceeds not applied or invested as provided in this paragraph will constitute "Excess Proceeds." When the aggregate amount of Excess Proceeds equals or exceeds $[___][93] million, Issuer will be required to make an offer to purchase from all Holders an aggregate principal amount of Notes equal to the amount of such Excess Proceeds (a "Net Proceeds Offer") in accordance with the procedures set forth in the Indenture.

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[92]The bondholders will generally not want debt of a later maturity repaid. The ability to repay identified debt of an earlier maturity may provide helpful flexibility for Issuer.

[93]This exception typically ranges from $10–20 million.

The offer price for the Notes will be payable in cash and will be equal to 100% of the principal amount of the Notes tendered pursuant to a Net Proceeds Offer, plus accrued and unpaid interest thereon, if any, to the date such Net Proceeds Offer is consummated (the "Offered Price"). If the aggregate Offered Price of Notes validly tendered and not withdrawn by Holders thereof exceeds the amount of Excess Proceeds, Notes to be purchased will be selected on a pro rata basis. Upon completion of such Net Proceeds Offer in accordance with the foregoing provisions, the amount of Excess Proceeds shall be reduced to zero.

To the extent that the aggregate Offered Price of Notes tendered pursuant to a Net Proceeds Offer is less than the Excess Proceeds (such shortfall constituting a "Net Proceeds Deficiency"), Issuer may use the Net Proceeds Deficiency, or a portion thereof, for general corporate purposes.

In the event of the Transfer of substantially all (but not all) of the assets of Issuer and the Restricted Subsidiaries as an entirety to a Person in a transaction covered by and effected in accordance with the covenant described under "— Merger, Consolidation and Sale of Assets," the Transferee shall be deemed to have sold for cash at Fair Market Value the assets of Issuer and the Restricted Subsidiaries not so Transferred for purposes of this covenant, and shall comply with the provisions of this covenant with respect to such deemed sale as if it were an Asset Sale (with such Fair Market Value being deemed to be Net Available Proceeds for such purpose).

Issuer shall comply, to the extent applicable, with the requirements of Section 14(e) of the Exchange Act and any other securities laws or regulations in connection with any purchase of Notes pursuant to the Indenture. To the extent that the provisions of any securities laws or regulations conflict with the provisions of the Indenture, Issuer shall comply with the applicable securities laws and regulations and will not be deemed to have breached its obligations under the Indenture by virtue of this compliance.

Relevant Definitions

"Asset Sale" means any Transfer by Issuer or any Restricted Subsidiary of:

- any shares of Capital Stock of a Restricted Subsidiary (other than directors' qualifying shares and, to the extent required by local ownership laws in foreign countries, shares owned by foreign shareholders);
- all or substantially all the assets of any division, business segment or comparable line of business of Issuer or any Restricted Subsidiary; or
- any other assets of Issuer or any Restricted Subsidiary outside of the ordinary course of business of Issuer or such Restricted Subsidiary.

Notwithstanding the foregoing, the term "Asset Sale" shall not include:

(1) for purposes of the covenant described under "— Certain Covenants — Limitation on Asset Sales," a Transfer that constitutes a Permitted Investment or a Restricted Payment permitted by the covenant described under "— Certain Covenants — Limitation on Restricted Payments" or consummated in compliance with the covenant described under "— Certain Covenants — Limitation on Sale of Principal Properties" or "— Certain Covenants — Merger, Consolidation and Sale of Assets";

(2) sales of accounts receivable of the type specified in the definition of "Qualified Securitization Transaction" to a Securitization Entity for the Fair Market Value thereof;

(3) sales or grants of nonexclusive licenses to use the patents, trade secrets, know-how and other intellectual property of Issuer or any Restricted Subsidiary to the extent that such licenses are granted in the ordinary course of business, and do not prohibit Issuer or any Restricted Subsidiary from using the technologies licensed and do not require Issuer or any Restricted Subsidiary to pay any fees for any such use;

(4) a Transfer pursuant to any foreclosure of assets or other remedy provided by applicable law by a creditor of Issuer or any Restricted Subsidiary with a Lien on such assets, which if such Lien is permitted under the Indenture;

(5) a Transfer involving only Temporary Cash Investments or inventory in the ordinary course of business;

(6) any Transfer of damaged, worn-out or obsolete equipment in the ordinary course of business;

(7) the lease or sublease of any real or personal property in the ordinary course of business; provided that, to the extent such property constitutes Collateral, such lease or sublease shall comply with the provisions of the applicable Security Documents;

(8) the sale at cost of equipment pursuant to a program in which participants agree to purchase or construct and maintain specific spare parts necessary to operate production facilities in the Permitted Business; or

(9) a Transfer of assets having a Fair Market Value and a sale price of less than $1.0 million.

"Net Available Proceeds" from an Asset Sale or a Sale of a Principal Property means the aggregate cash proceeds received by such Person and/or its Affiliates in respect of such transaction, which amount is equal to the excess, if any, of:

(1) the cash received by such Person and/or its Affiliates (including any cash payments received by way of deferred payment pursuant to, or monetization of, a note or installment receivable or otherwise, but only as and when received) in connection with such transaction, over

(2) the sum of (a) the amount of any Indebtedness that is secured by such asset and which is required to be repaid by such Person in connection with such transaction, plus (b) all fees, commissions, and other expenses incurred by such Person in connection with such transaction, plus (c) provision for taxes, including income taxes, attributable to the transaction or attributable to required prepayments or repayments of Indebtedness with the proceeds of such transaction, plus (d) a reasonable reserve for the after-tax cost of any indemnification payments (fixed or contingent) attributable to seller's indemnities to purchaser in respect of such transaction undertaken by Issuer or any of its Restricted

Subsidiaries in connection with such transaction, plus (e) if such Person is a Restricted Subsidiary, any dividends or distributions payable to holders of minority interests in such Restricted Subsidiary from the proceeds of such transaction.

SECURITIZATION RIDERS

Note: These riders assume that the Securitization Entity is an Unrestricted Subsidiary. Different, and more comprehensive, language would be required if it were to be a Restricted Subsidiary.

Carveout from Affiliate Transaction covenant:

"(__) transactions between Issuer or any Subsidiary and any Securitization Entity in connection with a Qualified Securitization Transaction, in each case provided that such transactions are not otherwise prohibited by the Indenture;"

Carveout from definition of Asset Sale:

"(__) sales of accounts receivable of the type specified in the definition of "Qualified Securitization Transaction" to a Securitization Entity for the Fair Market Value thereof;"

Carveout in definition of Permitted Investment:

"(__) any Investment by Issuer or a wholly owned Subsidiary of Issuer in a Securitization Entity; provided that such Investment is in the form of a Purchase Money Note or an equity interest or interests in accounts receivable generated by Issuer or any of its Subsidiaries;"

Carveout in definition of Permitted Liens:

"(__) Liens arising or that may be deemed to arise in favor of a Securitization Entity arising in connection with a Qualified Securitization Transaction;"

Certain Definitions

"Purchase Money Note" means a promissory note evidencing a line of credit, which may be irrevocable, from, or evidencing other Indebtedness owed to, Issuer or any of its Subsidiaries in connection with a Qualified Securitization Transaction, which note shall be repaid from cash available to the maker of such note, other than amounts required to be established as reserves pursuant to agreements, amounts paid to investors in respect of interest, principal and other amounts owning to such investors and amounts paid in connection with the purchase of newly generated receivables.

"Qualified Securitization Transaction" means any transaction or series of transactions that may be entered into by Issuer, any Restricted Subsidiary or a Securitization Entity pursuant to which Issuer or such Restricted Subsidiary or that Securitization Entity may, pursuant to customary terms, sell, convey or otherwise transfer to, or grant a security interest in for the benefit of, (1) a Securitization Entity or Issuer or any Restricted Subsidiary which subsequently transfers to a Securitization Entity (in the case of a transfer by Issuer or such Restricted Subsidiary) and (2) any other Person (in the case of transfer by a Securitization Entity), any accounts receivable (whether now existing or arising or acquired in the future) of Issuer or any Restricted Subsidiary which arose in the ordinary course of business of Issuer or such Restricted Subsidiary, and any assets related thereto, including, without limitation, all collateral securing such accounts receivable, all contracts and contract rights and all guarantees or other obligations in respect of such accounts receivable, proceeds of such accounts receivable and other assets (including contract rights) which are customarily transferred or in respect of which security interests are customarily granted in connection with asset securitization transactions involving accounts receivable.

APPENDIX B

PRELIMINARY PROCESS TIMELINE FOR NOTES OFFERING

Week	Key Events
1	Begin drafting ratings agency presentations Set up appointments with ratings agencies
2	Organizational meeting Begin due diligence and information gathering Begin drafting offering memorandum Review ratings agency presentations with the Issuer
3	Drafting session for offering memorandum Begin drafting roadshow presentations Finalize ratings agency presentations Rehearse and send presentations to ratings agencies Ratings agency meeting
4	Drafting session for offering memorandum Drafting roadshow presentation Ratings agency's analysts prepare internal analyses
5	Deliver audited financials and begin drafting comfort letter Request meeting with high yield analysts Finalize offering memorandum Receive ratings
6	Roadshow rehearsals Meet with high yield analysts Send offering memorandum to financial printer
7	Mail offering memorandum to investors Begin roadshow
8	End roadshow Pricing and closing Funding

APPENDIX C

SARBANES-OXLEY ACT OF 2002

I. Significant Provisions Applicable to High Yield Issuers

Operative Provision (and Section Numbers)	Applies Upon Issuance of Notes	Inapplicable Until Filing of Registration Statement
Prohibition on extending personal loans to executives (Section 402)		✓
Forfeiture of bonuses and profits if company issues an accounting restatement as a result of misconduct (Section 304)		✓
Principal executive officer and financial officer civil certification (Section 302)	✓	
Principal executive officer and financial officer criminal certification (Section 906)		✓
Conditions for use of Non-GAAP financial measures (Section 401)*		✓
Audit committee financial expert disclosure (Section 407)	✓	

*While these rules technically do not apply until the registration statement is filed, it is nonetheless a good idea to comply with them in public statements prior to that time for liability reasons.

Operative Provision (and Section Numbers)	Applies Upon Issuance of Notes	Inapplicable Until Filing of Registration Statement
Code of ethics disclosure (Section 406)	✓	
Disclosure in MD&A of off–balance sheet arrangements and aggregate contractual obligations (Section 401)	✓	
Restriction on providing nonaudit services and requirement of pre-approval of auditing and nonauditing services (Sections 201, 202 and 204)*	✓	
Auditor conflicts of interest (Sections 203, 206)*		✓
Prohibition on improperly influencing the conduct of audits (Section 303)*		✓
Management assessment of internal controls (Section 404)	✓	
Rapid and current "plain English" disclosure of material changes (Section 409)	✓	

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*Although auditor independence rules do not technically apply prior to filing the registration statement, they do apply to the auditors; therefore as a practical matter, it is important to comply these rules even prior to filing the registration statement. Similarly, while improper influence rules do not technically apply prior to filing the registration statement, exerting improper influence on an auditor is never a good idea, rules or no rules.

II. Significant Provisions Inapplicable to High Yield Issuers

Operative Provision (and Section Numbers)	Applicable To:
Audit Committee Independence (Section 301)	Listed companies
Requirement that the board of directors grant specified authority regarding auditors and audit process to audit committees (Section 301)	Listed companies
Requirement that audit committee establish whistleblower procedures (Section 301)	Listed companies
Prohibition of directors making trades during retirement plan blackout periods (Section 306)	Issuers of equity securities
Requirement that retirement plan administrator provide notice to plan participants of blackout periods (Section 306)	Issuers of equity securities
Requirement that directors and officers file Section 16 reports within two business days of trades (Section 403)	Issuers of equity securities
Requirement that company provide Section 16 reports on its website (Section 403)	Issuers of equity securities

APPENDIX D

TYPICAL DISCLOSURE RELATING TO EXCHANGE OFFER; REGISTRATION RIGHTS

We have entered into a Registration Rights Agreement pursuant to which we have agreed, for the benefit of the holders of the notes, that we will, at our cost,

(1) within [___] days after the issue date of the notes, file a registration statement (the "Exchange Offer Registration Statement") with the Commission with respect to a registered offer to exchange (the "Exchange Offer") the notes for notes, which will have terms substantially identical in all material respects to the notes (the "Exchange Notes"), except that the Exchange Notes will not contain terms with respect to transfer restrictions, and will be guaranteed by the guarantors on terms substantially identical in all material respects to the guarantees;

(2) within [___] days after the issue date of the notes, use our best efforts to cause the Exchange Offer Registration Statement to be declared effective under the Securities Act. Upon the Exchange Offer Registration Statement being declared effective, we will offer the Exchange Notes in exchange for surrender of the notes; and

(3) keep the Exchange Offer open for not less than 30 business days (or longer if required by applicable law) after the date notice of the Exchange Offer is mailed to the holders of the notes.

For each note surrendered to us pursuant to the Exchange Offer, the holder of such note will receive an Exchange Note having a principal amount equal to that of the surrendered note.

Under existing Commission interpretations, the Exchange Notes would in general be freely transferable after the Exchange Offer without further registration under the Securities Act; *provided* that, in the case of broker-dealers, a prospectus meeting the requirements of the Securities Act be delivered as required. We have agreed for a period of 180 days after consummation of the Exchange Offer to make available a prospectus meeting the requirements of the Securities Act to any broker-dealer for use in connection with any resale of any such Exchange Notes acquired as described below. A broker-dealer that delivers such a prospectus to purchasers in connection with such resales will be subject to certain of the civil liability provisions under the Securities Act, and will be bound by the provisions of the Exchange Offer Registration Rights Agreement (including certain indemnification rights and obligations).

Each holder of notes that wishes to exchange such notes for Exchange Notes in the Exchange Offer will be required to make certain representations including representations that

(1) any Exchange Notes to be received by it will be acquired in the ordinary course of its business;

(2) it has no arrangement with any person to participate in the distribution of the Exchange Notes; and

(3) it is not an "affiliate," as defined in Rule 405 of the Securities Act, of us or any of the guarantors, or if it is an affiliate, it will comply with the registration and prospectus delivery requirements of the Securities Act to the extent applicable.

If the holder is not a broker-dealer, it will be required to represent that it is not engaged in, and does not intend to engage in, the distribution of the Exchange Notes. If the holder is a broker-dealer that will receive Exchange Notes for its own account in exchange for notes that were acquired as a result of market-making activities or other trading activities, it will be required to acknowledge that it will deliver a prospectus in connection with any resale of such Exchange Notes.

In the event that applicable interpretations of the staff of the Commission do not permit us to effect such an Exchange Offer, or if for any other reason the Exchange Offer is not consummated within [___] days of the issue date of the notes or, under certain circumstances, if the initial purchasers shall so request, we will, at our own expense,

(1) as promptly as practicable, file a shelf registration statement covering resales of the notes (the "Shelf Registration Statement");

(2) use our best efforts to cause the Shelf Registration Statement to be declared effective under the Securities Act; and

(3) use our best efforts to keep effective the Shelf Registration Statement until the earlier of the disposition of the notes covered by the Shelf Registration Statement or two years after the issue date of the notes.

We will, in the event of the Shelf Registration Statement, provide to each holder of the notes copies of the prospectus which is a part of the Shelf Registration Statement, notify each such holder when the Shelf Registration Statement for the notes has become effective and take certain other actions as are required to permit unrestricted resales of the notes. A holder of the notes that sells such notes pursuant to the Shelf Registration Statement generally would be required to be named as a selling securityholder in the related prospectus and to deliver a prospectus to purchasers, will be subject to certain of the civil liability provisions under the Securities Act in connection with such sales and will be bound by the provisions of the Exchange Offer Registration Rights Agreement which are applicable to such a holder (including certain indemnification rights and obligations).

Although we intend to file one of the registration statements described above there can be no assurance that such registration statement will be filed or, if filed, that it will become effective. If we fail to comply with the above provisions or if such registration statement fails to become effective, then, as liquidated damages, additional interest shall become payable in respect of the notes as follows:

(1) if (a) neither the Exchange Offer Registration Statement nor the Shelf Registration Statement is not filed within [___] days after the issue date of the notes or (b) notwithstanding that we have consummated or will consummate an Exchange Offer, we are required to file a Shelf Registration Statement and such Shelf Registration Statement is not filed on or prior to the date required by the Exchange Offer Registration Rights Agreement;

(2) if (a) neither the Exchange Offer Registration Statement nor the Shelf Registration Statement is not declared effective within [___] days after the issue date of the notes or (b) notwithstanding that we have consummated or will

consummate an Exchange Offer, we are required to file a Shelf Registration Statement and such Shelf Registration Statement is not declared effective by the Commission on or prior to the 45th day following the date such Shelf Registration Statement was filed; or

(3) if either (a) we have not exchanged the Exchange Notes for all notes validly tendered in accordance with the terms of the Exchange Offer on or prior to the [___]th day after the issue date of the notes or (b) the Exchange Offer Registration Statement ceases to be effective at any time prior to the time that the Exchange Offer is consummated or (c) if applicable, the Shelf Registration Statement ceases to be effective at any time prior to the second anniversary of the issue date of the notes;

(each such event referred to in clauses (1) through (3) above is a "Registration Default"), the sole remedy available to holders of the notes will be the immediate assessment of additional interest ("Additional Interest") as follows: the per annum interest rate on the notes will increase by 0.25%, and the per annum interest rate will increase by an additional 0.25% for each subsequent 90-day period during which the Registration Default remains uncured, up to a maximum additional interest rate of 1.0% per annum in excess of the interest rate on the cover of this offering memorandum. All Additional Interest will be payable to holders of the notes in cash on each interest payment date, commencing with the first such date occurring after any such Additional Interest commences to accrue, until such Registration Default is cured. After the date on which such Registration Default is cured, the interest rate on the notes will revert to the interest rate originally borne by the notes (as shown on the cover of this offering memorandum).

The summary herein of certain provisions of the Exchange Offer Registration Rights Agreement does not purport to be complete and is subject to, and is qualified in its entirety by reference to, all the provisions of the Exchange Offer Registration Rights Agreement, a copy of which will be available upon request to us.

APPENDIX E

ACME PRODUCTS, INC.
QUESTIONNAIRE
FOR OFFERING MEMORANDUM

NAME:____

TITLE:____

Acme Products, Inc. (the "Company") is preparing an Offering Memorandum in connection with an offering of senior subordinated notes. This questionnaire is being distributed to (i) all persons who are directors (and nominees for election of directors, if any) of the Company, (ii) all persons who are or will be executive officers of the Company and (iii) each person who will own of record or beneficially more than 5% of any class of voting securities of the Company. Please see the accompanying Explanatory Notes for an explanation of terms used herein and identified with an endnote.

This questionnaire is being sent to you because of your status which falls in one of the categories listed in the prior paragraph.

Please complete, sign and return this Questionnaire as soon as possible to Gerald T. Nowak, Kirkland & Ellis, 200 East Randolph Drive, Chicago, Illinois 60601. We suggest that you retain a copy of the completed Questionnaire for your files.

Instructions as to which Questions to Answer:

(i) Present directors and nominees for election as directors should answer all questions except Questions 7 and 20.

(ii) Present executive officers(1) and persons chosen to be executive officers should answer all questions except Questions 5, 6 and 19.

(iii) Holders of more than 5% of any class of the Company's voting securities should answer Questions 4, 12, 13, 16, 18, 21, 22, 23, 25, 26 and 27.

GENERAL

QUESTION 1.

(a) We plan to report your name, age and principal occupation, your principal occupation and employment during the last five years, and the name and principal business of any corporation or other organization in which such occupations and employment are or were performed.

The following is an example of the format we will use. Please provide the necessary information in the space provided below the example.

"*I.M. Officer*, 49, has served as our chief executive officer since July 2000. Prior to that time, Mr. Officer was a Senior Vice President of Marketing of ABC Corporation, a global widget manufacturer, from June 1997 to July 2000. He joined ABC Corporation in 1992 and has held numerous sales and operations positions for various ABC businesses. Mr. Officer is a director of DEF, Inc., a publicly traded gadget manufacturer.

M. Director, 52, has been one of our directors since July 2000. Mr. Director is currently Senior Vice President and Director of Corporate Development for DEF, Inc., a global thingamabob manufacturer, and has held various positions of increasing responsibility with DEF since 1997. Prior to that time, he served as a Vice President of Business Development for GHI Corporation, a global whatsit manufacturer."

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(b) Please provide us with your date of birth so we can update your age as time passes.

____

(c) If you are an executive officer(1) and have been employed by the Company or one of its subsidiaries(2) for less than five years, explain briefly the nature of your responsibilities in prior positions during the past five years to the extent not set forth under (a) above or described in the Offering Memorandum.

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QUESTION 2.

Describe any arrangement or understanding between yourself and any other person or persons[3] (other than directors and officers of the Company acting solely in their capacities as such) pursuant to which you were selected as a director, as a nominee for election as director, as an executive officer[1] or as a person chosen to be an executive officer of the Company. Include the name or names of such other person or persons.

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FAMILY RELATIONSHIPS

QUESTION 3.

Describe any relationships by blood, marriage or adoption (not more remote than first cousin) between you and any other director or executive officer[1] of the Company, or any person nominated or chosen to become a director or an executive officer[1] of the Company.

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QUESTION 4.

Please list all members of your immediate family[(4)], whether or not they live in your home.

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DIRECTORSHIPS

QUESTION 5.

Name any other companies (including investment companies) of which you are a director that file periodic reports with the Securities and Exchange Commission. (You need not indicate any such relationships previously referred to in your response to Question 1).

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BUSINESS RELATIONSHIPS

QUESTION 6.

If now or at any time during the three years ended [FY End], you have or have had any of the following relationships, or any relationship substantially similar in nature and scope, name the business or professional entity: (i) an executive officer[(5)] of, or owner (of record or beneficially) of a more than 10% equity interest in, any business or professional entity, (ii) a member of, or of counsel to, a law firm or (iii) a partner or executive officer[(5)] of an investment banking firm. (You need not indicate any such relationships previously referred to under Question 1.)

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QUESTION 7.

If you are an executive officer[(5)], disclose any of the following relationships which existed during the last completed fiscal year (*i.e.*, [FY End]).

(a) Have you served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire Board of Directors) of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire Board of Directors) of the Company?

Yes ☐ No ☐

(b) Have you served as a director of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire Board of Directors) of the Company?

Yes ☐ No ☐

(c) Have you served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire Board of Directors) of another entity, one of whose executive officers served as a director of the Company?

Yes ☐ No ☐

If you answered yes to any of these questions, please provide details.

LEGAL PROCEEDINGS

QUESTION 8.

During the past five years[6], has a petition under any Federal or State bankruptcy or insolvency law been filed by or against, or a receiver, fiscal agent or similar officer been appointed by a court for the business or property of, (i) you, (ii) any partnership in which you were or, within the two years before the date thereof, had been a general partner or (iii) any corporation or business association of which you were or, within the two years before the date thereof, had been an executive officer[5]? If so, provide details.

QUESTION 9.

During the past five years[6], have you been convicted in a criminal proceeding or are you now the named subject of a pending criminal proceeding (excluding traffic violations and other minor offenses)? If so, provide details.

QUESTION 10.

During the past five years[(6)], have you been the subject of any order, judgment or decree (not subsequently reversed, suspended or vacated) of (i) any court of competent jurisdiction permanently or temporarily enjoining or otherwise limiting you from (x) acting as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, floor broker, leverage transaction merchant, any other person regulated by the Commodity Futures Trading Commission, or an associated person of any of the foregoing, or as an investment adviser, underwriter, broker or dealer in securities, or as an affiliated person, director or employee of any investment company, bank, savings and loan association or insurance company, or engaging in or continuing any conduct or practice in connection with any such activity; (y) engaging in any type of business practice; or (z) engaging in any activity in connection with the purchase or sale of any security or commodity or in connection with any violation of Federal or State securities laws or Federal commodities laws; or (ii) any Federal or State authority barring, suspending or otherwise limiting, for more than 60 days, your right to be engaged in any such activity or to be associated with persons engaged in any such activity? If so, provide details.

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QUESTION 11.

During the past five years[(6)], have you been found by a court of competent jurisdiction in a civil action or by the Securities and Exchange Commission to have violated any Federal or State securities law or have you been found by a court of competent jurisdiction in a civil action or by the Commodity Futures Trading Commission to have violated any Federal commodities law (which judgment or finding has not, in any such case, been subsequently reversed, suspended or vacated)? If so, provide details.

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QUESTION 12.

Describe any legal proceeding to which you or any associate[(7)] is a party adverse to the Company or any of its subsidiaries[(2)] or in which you or such associate has a material interest adverse to the Company or any of its subsidiaries.

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QUESTION 13.

(a) To your knowledge, is the Company or any of its subsidiaries a party to, or are any of their properties subject to, any material pending legal proceedings?

Yes ☐ No ☐

(b) To your knowledge, is any director, executive officer[(5)], affiliate[(6)] or any principal stockholder of the Company, or any of their associates, a party adverse to the Company or does any such person have a material interest adverse to the Company or any of its subsidiaries in any material proceedings?

Yes ☐ No ☐

(c) To your knowledge, is the Company or any of its subsidiaries a party to, or are any of their properties subject to, any material pending legal proceedings relating to the discharge of materials into the environment or to laws, rules or regulations protecting the environment?

Yes ☐ No ☐

If the answer is "yes" to any of the above questions, please provide details.

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QUESTION 14.

If you are a director or executive officer[(5)], are you insured or indemnified in any manner against any liability which you may incur in your capacity as a director or officer of the Company, other than as provided in the Company's Certificate of Incorporation or By-laws?

Yes ☐ No ☐

COMPENSATION

QUESTION 15.

Please refer to the broad definition of compensation in Explanatory Note (8) and note that all consideration (whether or not received by you) from any third party, including, but not limited to, any of the Company's parents[(9)] and subsidiaries[(2)], for your services to the Company or any of its subsidiaries is "compensation" for the purpose of this Question 15.

Please indicate below (i) whether you have received compensation from any person[(3)] for services to the Company or any of its subsidiaries rendered during the fiscal year ended [FY End]; (ii) whether any such compensation has been paid, set aside or accrued by any person in respect of such year for your benefit; and (iii) whether any such compensation is proposed to be paid in the future.

You need not indicate any receipt from, or payment, proposed payment, grant or accrual by, the Company or any of its subsidiaries of (i) director's fees pursuant to standard arrangements, salary, bonuses or commissions; (ii) reimbursement of out-of-pocket expenses incurred in the performance of your duties; (iii) options; (iv) stock appreciation rights; (v) annuity, pension or retirement benefits; (vi) costs or other benefits under life, health, hospitalization or other medical reimbursement plans; (vii) any profit derived from the exercise of options to purchase Company stock granted by the Company or any of its subsidiaries; (viii) any profit derived from the exercise of stock appreciation rights granted by the company or any of its subsidiaries; or (ix) any other benefits under written plans or arrangements with the Company or any of its subsidiaries.

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QUESTION 16.

State below if you (i) served as a member of the compensation committee of the Company's Board of Directors or other board committee performing equivalent functions or (ii) participated in deliberations of the Company's Board of Directors concerning executive officer compensation during the last completed fiscal year (*i.e.,* [FY End]).

Yes ☐ No ☐

INDEBTEDNESS

QUESTION 17.

If (i) you; (ii) any corporation or organization (other than the Company or a majority-owned subsidiary of the company) of which you are an executive officer(5) or a partner or are, directly or indirectly, the beneficial owner(10) of 10% or more of any class of the Company's equity securities; (iii) any trust or other estate in which you have a substantial beneficial interest or as to which you serve as a trustee or in a similar capacity; or (iv) to your reasonable knowledge, any member of your immediate family(4), have been indebted(11) to the Company or any of its subsidiaries(2) in an amount in excess of $60,000 at any time since the past three years or since that time, state the largest aggregate amount of indebtedness outstanding at any time during such period, the nature of the indebtedness and of the transaction in which it was incurred, the amount outstanding as of a recent date and the rate of interest paid or charged thereon. If the indebtedness is that of a corporation, organization, trust, estate or person set forth in clause (ii), (iii) or (iv) above, name such corporation, organization, trust, estate or person and describe the nature of the relationship of such corporation, organization, trust, estate or person to you.

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TRANSACTIONS

QUESTION 18.

Describe briefly any transaction(12), or series of similar transactions, since [FY End], or any proposed transaction, or series of similar transactions, to which the Company or any of its subsidiaries(2) was or is to be a party, in which you, or, to your reasonable knowledge, any member of your immediate family(4), had or is to have a direct or indirect(13) material interest(14). (You need not describe any transaction or series of similar transactions, including all periodic installments in the case of any lease or other agreement providing for periodic payments or installments, involving less than $60,000.) Please name the person whose interest requires the description and state his or her relationship to the Company, the nature of his or her interest in the transaction, the amount of the transaction and, where practicable, the amount of the interest.

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QUESTION 19.

If you are one of the promoters of the Company, provide the following information:

(a) The nature and amount of anything of value (including money, property, contracts, options or rights of any kind) received or to be received by you, directly or indirectly, from the Company and the nature and the amount of any assets, services or other consideration therefor received or to be received by the Company.

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(b) As to any assets acquired or to be acquired by the Company from you, state the amount at which the assets were acquired or are to be acquired and the principle followed or to be followed in determining such amount and identify the persons making the determination and their relationship, if any, with the Company or any promoter. If the assets were acquired by you within two years prior to their transfer to the Company, also state the cost thereof to you.

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QUESTION 20.

Describe any compensation(8) plan or arrangement, including payments to be received from the Company, to which you are a party if such a plan or arrangement results or will result from your resignation or retirement or any other termination of your employment with the Company or any of its subsidiaries(2), or from any change in control. (You need not describe any plan or arrangement where the amount involved in the transaction, including all periodic payments or installments, does not exceed $60,000. You also need not describe compensation or transactions indicated in response to Question 15, 17 or

18 or any compensation specifically omitted from your response to Question 15 pursuant to such Question.)

QUESTION 21.

State whether you are a party to any contract to which the Company or any of its subsidiaries[(2)] is a party or has succeeded to a party by assumption or assignment, or in which the Company or any of its subsidiaries has a beneficial interest, to be performed in whole or in part at or after the date of the transaction, or entered into not more than two years prior thereto. If so, please identify such contract.

QUESTION 22.

Do you know or have any reason to believe that any of the activities or types of conduct enumerated below have been or may have been engaged in, directly or indirectly, within or outside the United States, at any time since the beginning of the Company's last fiscal year (*i.e.,* [FY End]) to date?

(Notes: Each question is to be read as relating to the activities or conduct of the Company, and any affiliate[(16)] of the Company, as well as to the conduct of any person who has acted or is acting on behalf of or for the benefit of any of them.

The terms "payments" and "contributions" include not only the giving of cash or hard goods but also the giving of anything else of value (*e.g.,* services or the use of property).

Your answers should consider not only matters of which you have direct personal knowledge, but also those matters which you have reason to believe may have existed or occurred.)

(a) Any bribes or kickbacks to government officials or other persons, or their relatives, or any other payments to such persons, whether or not legal, to obtain or retain business or to receive favorable treatment with regard to business.

Yes ☐ No ☐

(b) Any contributions, whether or not legal, made to any political party, political candidate or holder of governmental office.

Yes ☐ No ☐

(c) Any bank accounts, funds or pools of funds created or maintained without being reflected on the corporate books of account, or as to which the receipts and disbursements therefrom have not been reflected on such books.

Yes ☐ No ☐

(d) Any receipts or disbursements, the actual nature of which has been "disguised" or intentionally misrecorded on the corporate books of account.

Yes ☐ No ☐

(e) Any fees paid to consultants or commercial agents which exceeded the reasonable value of the services purported to have been rendered.

Yes ☐ No ☐

(f) Any payments or reimbursements made to personnel of the Company for purposes of enabling them to expend time or to make contributions or payments of the kind or for the purposes referred to in (a) through (e) above.

Yes ☐ No ☐

If your answer to any of the foregoing questions is "yes," give details in the space below.

SECURITY OWNERSHIP

QUESTION 23.

You may limit your answer to this question to beneficial ownership[(10)] by (i) you, (ii) members of your immediate family[(4)], (iii) any "group" in which you are a member, (iv) your associates[(7)] and (v) any corporation or other organization with which you have an employment or other significant connection. Subject to those limitations, if any person[(3)] (including for this purpose a "group," which may consist of two or more persons acting as a partnership, limited partnership, syndicate or other group for the purpose of acquiring, holding, voting or disposing of securities of the Company) is known to you to be the beneficial owner[(10)] of more than 5% of any class of the Company's voting securities as listed in the first column below, complete the table below to the extent of the information available to you. Please footnote the third column to show, to the extent of the information available to you, (i) the number of such securities with respect to which the beneficial owner[(10)] has the right to acquire beneficial ownership, the number with respect to which the power of investment or the power to vote, or both, is held and, if any such power is shared, the persons with whom it is shared and (ii) where the holder(s) named in the table holds more than 5% of any class of the Company's voting securities pursuant to a voting trust or similar agreement, state the amount held or to be held subject to such trust or agreement, the duration of the agreement and the names and addresses of the voting trustees and outline briefly their voting rights and other powers under the trust or agreement.

Title of Class	Name and Address (business, mailing or residence) of Beneficial Owner	Amount and Nature of Beneficial Ownership After the Recapitalization
Class A Voting Common Stock		
Class B Voting Common Stock		
Class C Non-Voting Common Stock		
Series A Preferred Stock		

QUESTION 24.

Set forth below the amount of each class of equity securities (including any puts, calls, straddles or other options)(15) of the Company, any of its parents(9) or any of its subsidiaries(2) owned beneficially(10) by you. Please footnote the second column to show the number of such securities with respect to which you have the right to acquire beneficial ownership(10), the number with respect to which the power of investment or the power to vote, or both, is held by you and, if any such power is shared, the persons with whom it is shared.

Title of Class	Amount and Nature of Beneficial Ownership

QUESTION 25.

Describe any arrangements known to you (including any pledge of securities of the Company or any of its parents(9)) the operation of the terms of which may at a subsequent date result in a change in control of the Company. (Ordinary default provisions in the charter, trust indentures or other governing instruments relating to securities of the Company need not be described.)

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QUESTION 26.

Is there to your knowledge any arrangement made or to be made by any person for the period of the distribution of the Notes in the proposed offering for the purpose of (a) limiting or restricting the sale of the Notes; (b) stabilizing the market for the Notes; (c) allocating the Notes to you or any of your associates or to any officer, director, 5% stockholder, employee, or customer of the Company; (d) withholding commissions, or otherwise to hold each underwriter or dealer responsible for the distribution of his participation; or (e) payment of any finder's fee or similar commission?

Yes ☐ No ☐

If so, please describe:

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Have you or any of your associate at any time been interested in or affiliated or otherwise connected with or had any material relationship with the independent certified public accountants or legal counsel which the Company has retained in the past or proposed to retain in the current fiscal year?

Yes ☐ No ☐

If so, please describe:

FURTHER INFORMATION

QUESTION 27.

If you know of any additional information necessary to make the answers you have given above not misleading in the light of the circumstances under which your answers were made, furnish it below.

If, at any time prior to the effective date of the Offering Memorandum any of the information set forth in my responses to this Questionnaire has changed due to passage of time, or any development occurs which requires a change in my answer, or has for any other reason become incorrect, I will forthwith furnish to the person named on the front page of this Questionnaire, at the address indicated, any necessary or appropriate correcting information. Otherwise, the Company is to understand that the above information continues to be, to the best of my knowledge, information and belief, complete and correct as of the effective date of the Offering Memorandum.

* * * * *

The information set forth above is supplied by me for use in the preparation of the Offering Memorandum.

If I am a nominee for director or have been chosen to be an executive officer, I confirm my consent to being named as such in the Offering Memorandum and to serve as such if elected or appointed.

I will notify the Company immediately of any changes in the foregoing answers which should be made as a result of any material developments occurring prior to the effective date of the Offering Memorandum.

Dated:

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Explanatory Notes

(1) "*Executive Officer*" includes the Company's president, chief financial officer, controller, presidents of its principal business units, and officers with a policy making function.

(2) A list of the Company's subsidiaries is attached as Annex A.

(3) For the purposes of this Questionnaire, "*person*" means a natural person, a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in a case under Title 11 of the United States Code or similar official or any liquidating agent for any of the foregoing in his capacity as such; or a government, or a political subdivision, agency or instrumentality of a government.

(4) A person's "*immediate family*" includes such person's spouse, parents, children, brothers and sisters, mothers- and fathers-in-law, sons- and daughters-in-law, and brothers- and sisters-in-law.

(5) For purposes of Questions 6, 7 and 13, an "*executive officer*" of an entity includes the entity's President, any Vice President of the entity in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the entity, including any executive officers of subsidiaries of the entity who perform such policy-making functions for the entity.

(6) In determining your response, the date of the events referred to shall be deemed the date on which the final order, judgment or decree was entered, or the date on which any rights of appeal from preliminary orders, judgments or decrees lapsed. With respect to bankruptcy petitions, such date shall be the date of filing for uncontested petitions or the date upon which approval of a contested petition became final.

(7) An "*associate*" of a person means:

(i) any corporation or organization (other than the Company or a majority-owned subsidiary of the Company) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10% or more of any class of equity securities;

(ii) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar capacity; and

(iii) any relative or spouse of such person, or any relative of such spouse, who has the same home as such person or who is a director or officer of the Company or any of its parents or subsidiaries.

If a person was an "associate" at the time of the transaction in question, then that person should be considered an "associate" even though that person may no longer be an "associate."

(8) For purposes of this Questionnaire, "*compensation*" includes all consideration, from whatever source, for services in all capacities to the Company and any of its subsidiaries, including transactions between the Company and a third party when the primary purpose of the transaction is to furnish compensation to you.

Compensation includes personal benefits ("perks"), if any, furnished by the Company or any of its subsidiaries, directly or through a third party. According to the Securities and Exchange Commission, personal benefits include, among other things; (i) the use for personal, as opposed to business, purposes of cars, planes, apartments, houses or other corporate assets; (ii) the use for personal purposes of club memberships held or paid for by the Company or a subsidiary, directly or through a third party; (iii) living expenses at principal, temporary, vacation or other residences paid by the Company or a subsidiary, directly or through a third party, if not incurred in connection with a business matter; (iv) repayments by the Company or a subsidiary, directly or through a third party, for maintenance, repairs or improvements to your home; (v) the use of corporate professional staff or outside auditors, counsel or other professional services with respect to purely personal matters; and (vi) loans from the Company or a subsidiary on terms which are not commercially reasonable or the funds for which the Company or a subsidiary borrowed at a higher rate than it is charging, and may include, dependent on the facts and circumstances, the receipt of a loan from a creditor for which such creditor is deemed to be compensated by the Company or a subsidiary based on such factors as the maintenance of, or an increase in, compensating balances, an agreement to provide additional business or an increase in the interest rates paid by the Company or a subsidiary.

Benefits, including those referred to in the preceding paragraph, provided other than by the Company or any of its subsidiaries (directly or through a third party) which are for your services in any capacity to the Company or any of its subsidiaries or which are provided or used in connection with the business of the Company or any of its subsidiaries may constitute, in certain circumstances, compensation and, therefore, should be considered compensation for the purposes of Questions 15 and 20.

Of course, any of the above-mentioned benefits would not constitute compensation if paid for by you on a reasonable basis.

(9) A list of the Company's parents, if any, is attached.

(10) For the purposes of this Questionnaire, a person is deemed to have "*beneficial ownership*" of securities over which such person, directly or indirectly through any contract, arrangement, understanding, relationship or otherwise, has or shares (i) voting power (which includes the power to vote or to direct the voting of such securities) or (ii) investment power (which includes the power to dispose or direct the disposition of such securities).

A person is also deemed to be the beneficial owner of securities:

(i) the beneficial ownership of which such person has the right, at any time within 60 days, to acquire, including, but not limited to, any right to acquire through the exercise of options, warrants or rights, the conversion of a convertible security or the revocation or automatic termination of a trust or discretionary account or similar arrangement;

(ii) the beneficial ownership of which such person has the right to acquire (as specified in (i)) at any time, where such right is acquired for the purpose, or with the effect, of changing or influencing control of the Company, or in connection with or as a participant in any transaction having such purpose or effect; or

(iii) with respect to which such person, directly or indirectly, through the creation or use of a trust, a proxy, power of attorney, pooling arrangement or any other contract, arrangement or device purports to have divested himself of beneficial ownership or to have prevented the vesting of beneficial ownership as part of a scheme to evade the reporting requirements of Section 13(d) or (g) of the Securities Exchange Act of 1934.

In interpreting the above-described provisions, the Securities and Exchange Commission has taken the position that a person has indirect beneficial ownership of securities where such person controls the person that has the power to direct the voting or investment of such securities.

In applying these definitions to concrete situations, three key concepts — to a large extent interrelated — emerge as central considerations:

(a) <u>Whether one has the power to vote or dispose of securities that is essential to a finding of beneficial ownership is not a matter of legal title or authority but a question of fact which can go beyond legal forms</u>. Where you do not have the power to vote or invest securities, directly or indirectly, you are not considered the beneficial owner. Thus, if you are a beneficiary of an estate or trust, you are not, solely by reason of that fact, deemed the beneficial owner of securities held by such estate or trust. The same conclusion applies, absent other facts, to securities held by mutual funds or by pension or profit-sharing plans in which you have an interest (assuming no right to terminate participation and receive a distribution in kind within 60 days); to trusts of which you are settlor but not trustee and as to which you have no right of revocation exercisable within 60 days; and to other securities in which you retain some interest other than the power to vote or to direct their disposition.

(b) <u>Power to vote or to direct investment in securities confers beneficial ownership whether exercised directly or indirectly</u>. Many of the examples cited above serve to illustrate this point as well. Thus, you would be considered the beneficial owner of securities held by any corporation controlled by you, whether directly or through intermediaries, and of securities held by a partnership of which you are a member. Power to control or direct the voting of or investment in securities held by another person (individual or corporate), whether by contract or otherwise, dictates the same conclusion. And, of course, the reporting requirement cannot be circumvented by an arrangement nominally or temporarily to divest a person of beneficial ownership as part of a plan or scheme to evade such reporting requirements.

(c) It is sufficient to confer beneficial ownership if voting or investment powers are shared with others. This principle can result in a situation where the same shares may be deemed beneficially owned by a number of persons. Thus, for example, where co-trustees share voting and/or investment power over securities held in the trust, each will be deemed the beneficial owner of such securities. Similarly, although the SEC has not expressly so stated, it appears that where, by virtue of a position as a director or trustee of a business corporation, insurance company, bank, charitable foundation, pension fund or the like, you share the power to direct the voting and disposition of securities in that institution's portfolio, you may be considered the beneficial owner in your own right of all such securities. Where as an officer or employee you have portfolio management responsibilities which confer upon you the authority to sell securities held by an institution, beneficial ownership may also be attributed to you.

(11) "*Indebtedness*" is construed by the Securities and Exchange Commission to include any liability of an officer, director or 10% shareholder to the Company under Section 16(b) of the Securities Exchange Act of 1934. In determining the amount of "indebtedness," there would be excluded all amounts due for purchases subject to usual trade terms, for ordinary travel and expense advances, and for other transactions in the ordinary course of business (other than loans).

(12) "*Transaction*" includes the purchase, sale or lease of assets from or to the Company or any subsidiary, the rendering of services in any capacity for remuneration from the Company or any of its subsidiaries, directly or indirectly, and any loan to the Company or any subsidiary.

No information need be given in answer to Question 18 as to any transaction or interest therein where:

(i) the rates or charges involved are determined by competitive bids or the transaction involves the rendering of services as a common or contract carrier or public utility at rates or charges fixed in conformity with law or governmental authority;

(ii) the transaction involves services as a bank depositary of funds, transfer agent, registrar, trustee under a trust indenture or similar services;

(iii) the interest of the specified person arises solely from the ownership of securities of the Company and the specified person receives no extra or special benefit not shared on a *pro rata* basis by all holders of securities of the class; or

(iv) the transaction is indicated in response to Question 15 or 17 or specifically omitted from your response pursuant to Question 15.

(13) An "*indirect*" interest in the transaction may arise because of a position or relationship with a firm, corporation or other entity which engages in the transaction, except that no material indirect interest is deemed to arise where (i) the interest arises only from a position as a director of another corporation or organization which is a party to the transaction or (ii) the interest arises solely from the holding of an equity interest (including a limited partnership interest but excluding a general partnership interest) or a creditor interest in another party to the transaction and the transaction is not material as to such other party.

(14) In determining the materiality of any interest or transaction, the importance of the interest to the person having the interest, the relationship of the parties to the transaction to each other and the amount involved in the transaction are among the factors to be considered.

(15) "Equity security" means any stock or similar security, certificate of interest or participation in any profit-sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; or any security convertible, with or without consideration, into such a security or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle or other option or privilege of buying such a

security from or selling such a security to another without being bound to do so.

(16) “*Affiliate*” means a person that directly or indirectly, through one or more intermediaries, controls, is controlled by or is under common control with the Company and includes the Company’s parents, if any, and subsidiaries.

ANNEX A
TO
QUESTIONNAIRE

List of the Company's Subsidiaries

Acme Rocket Sandals, Inc.
Acme Anvils, Inc.

APPENDIX F

ACME PRODUCTS, INC.

375 Runner Road
Phoenix, Arizona

December 31, 2004

Securities and Exchange Commission
450 Fifth Street, N.W.
Judiciary Plaza
Washington, D.C. 20549

Re: Acme Products, Inc. Registration Statement on Form S-4 (SEC File No. 333-111111), filed on December 31, 2003

Ladies and Gentlemen:

This letter is to supplementally advise the Securities and Exchange Commission (the "Commission") that Acme Products, Inc. (the "Registrant") is registering its exchange offer, as described in the Registration Statement on Form S-4 filed with the Commission today (the "Registration Statement"), in reliance on the Commission's position enunciated in *Exxon Capital Holdings Corporation* (available May 13, 1988), *Morgan Stanley & Co., Inc*. (available June 5, 1991), and *Shearman & Stearling* (available July 2, 1993).

The Registrant hereby represents that it has not entered into any arrangement or understanding with any person to distribute the exchange notes to be received in the exchange offer and, to the best of the Registrant's information and belief, each person participating in the exchange offer is acquiring the exchange notes in the ordinary course of business and has no arrangement or understanding with any person to participate in the distribution of the exchange notes to be received in the exchange offer. In this regard, the Registrant hereby represents that it will make each person participating in the exchange offer aware (through the exchange offer prospectus) that (1) if such person is participating in the exchange offer for the purpose of distributing the exchange notes to be acquired in the exchange offer, such person (i) cannot rely on the Commission's position in *Exxon Capital, Morgan Stanley* and *Shearman & Sterling* or other interpretative letters to similar effect and

(ii) must comply with the registration and prospectus delivery requirements of the Securities Act of 1933, as amended (the "Securities Act"); and (2) any broker-dealer who holds existing notes acquired for its own account as a result of market-making activities or other trading activities and who is participating in the exchange offer, may be a statutory underwriter and must deliver a prospectus meeting the requirements of the Securities Act in connection with any resale of such exchange notes. The Registrant further acknowledges that such a secondary resale transaction by such person participating in the exchange offer for the purpose of distributing the exchange notes should be covered by an effective registration statement containing the selling securityholder information required by Item 507 of Regulation S-K.

Furthermore, the Registrant acknowledges that it will include in the letter of transmittal to be executed by an exchange offeree in order to participate in the exchange offer a provision providing that if the exchange offeree is a broker-dealer holding existing notes acquired for its own account as a result of market-making activities or other trading activities, that such exchange offeree acknowledges that it will deliver a prospectus meeting the requirements of the Securities Act in connection with any resale of exchange notes received in the exchange offer.

If you have any questions or comments, please contact the undersigned at (XXX) XXX-XXXX or Gerald T. Nowak of Kirkland & Ellis at (312) 861-2075.

Sincerely,

ACME PRODUCTS, INC.

/s/ Wyle E. Coyote
Name: Wyle E. Coyote
Title: President

cc: Gerald T. Nowak, *Kirkland & Ellis*

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