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The Gift that Keeps on Giving: Negotiating the High Yield Indenture

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Introduction

High yield debt is an integral part of the capital structure of many private equity sponsored portfolio companies. Its principal benefit to the sponsor is to provide long-term debt financing to the portfolio company 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, as well as the possibility of capital appreciation as the credit quality of the portfolio company improves over time. Because of the mutual benefits to sponsors and investors, high yield notes have become an important fixture in the array of financing vehicles available to the private equity sponsor when financing the acquisition or recapitalization of a portfolio company. Largely fueled by the private equity sponsor market, the total value of high yield debt offerings in 2004 was a record \$163 billion (Thomson Financial Securities Data).

The importance of high yield debt to the private equity sponsor highlights the importance of a deeper

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understanding of the instrument itself.

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.

The other critical distinction between a credit agreement and a high yield indenture is the time horizon of the instrument and flexibility to amend it 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 consent solicitation, which is costly and time consuming. It is this aspect of the high yield indenture that demands the private equity sponsor's attention. There is but one chance to get it done, and get it done right. It is truly "the gift that keeps on giving."

Philosophy

When negotiating the high yield indenture, 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. 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, including through sale-leaseback transactions; your assets are much more valuable to us if they remain unencumbered;
- ⊙ do not cut sweetheart deals with your affiliates; these just 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 your other debt; 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 your creditors.

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 eliminate or at least minimize the risk of costly and unpredictable litigation down the road.

Negotiating the Indenture

Negotiating a high yield indenture is unlike any other negotiation in a variety of ways. 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.

The more substantive difference in these negotiations is that the roles and incentives of the various parties are less than clear cut. The sponsor and the portfolio company, for example, clearly want maximum flexibility, but at the same time want the notes to be marketable, and marketability will suffer if the note terms differ materially from investor expectations. The investment banks’ primary interest seems to be in keeping the indenture within the range of marketability, but at the same time they are also acting as financial advisors and should be looking out for the sponsor’s financial interests. Adding to the complexity is the investment banks’ interest in “franchise issues,” *i.e.*, maintaining their credibility with buy-side players. Finally, in a situation where the high yield notes are being issued in connection with the acquisition of a portfolio company, the sponsor and the company are essentially on the same side of the table when negotiating the indenture while they are simultaneously negotiating against each other in the acquisition transaction.

That all said, the negotiation itself resembles a typical credit negotiation in which investment banks’ counsel

will present a document that contains some, but not all, of the typical carveouts that a sponsor can expect to receive. Issuer's counsel will then work with the sponsor and the portfolio company to prepare a mark-up that addresses the company's needs and brings the description of notes up to what, in issuer's 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 investment banks' 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 sponsor and the company, and their role as financial advisor on the part of the investment bankers; once that epiphany takes place, the parties tend to resolve their differences quickly and without unnecessary drama.

Involvement of the private equity professionals and the portfolio company's CFO and financial and accounting staff in this process is essential. Rarely will issuer's counsel be able to anticipate all of the specific flexibility the company needs. Even the so-called boilerplate provisions 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 testing 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 instruments. 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.

The Credit Parties

Before entering into a detailed discussion 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, non-guarantor 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 ability to repay certain 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.

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 non-public 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 domestic subsidiaries, and possibly the parent, guaranteeing the debt, although the parent guarantee creates some complications under the Sarbanes-Oxley Act as discussed below. 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.

The 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 holding company. The purpose of the guarantee is to create a direct obligation on the part of the guarantors.

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 investment banks may recommend it to enhance their marketing of the notes. The question of whether to provide a parent guarantee is also influenced by the senior secured 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. 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 guarantee. Of course, this assumes that the parent is not itself a public reporting company subject to Sarbanes-Oxley because of its own publicly traded equity or other public debt. 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 public 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 intercompany financing 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.

Non-Guarantor 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 dividended 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.

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 non-guarantors. This means that all income produced by these subsidiaries is counted for purposes of compliance with the various covenants described below, and these sub-

subsidiaries are all limited in their ability to take the various actions that are limited by those covenants. The distinction between guarantors and non-guarantor 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.

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, and all transactions with the unrestricted subsidiary must be permitted by the transactions with affiliates covenant, 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.

The Covenant Package

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 bondholders’ claims against the assets and cash flow of the issuer and guarantors. In addition, increased debt service requirements can weaken the credit to the detriment of the 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, typically 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 typically 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 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 bonds 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 that 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, a basket for debt issued under the company’s senior credit facilities. Indentures will also contain a “hell or high water” basket, which 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. 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. This structural subordination is the reason for, and its effects are intended to be reduced by, the subsidiary guarantees.

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. 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 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. For an issuer that is either owned by a non-guarantor holding company or has an obligation to make management fee payments to its private equity sponsor, a carveout must be negotiated for money to be dividended up to the parent to pay its expenses, *e.g.*, franchise taxes and other expenses, or to pay the management fee.

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.

Two notes about joint ventures: first, most high yield indentures allow limited flexibility for joint ventures, and second, forming and operating a joint venture tends to create difficult interpretive questions under the indenture. The reason 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. Issuers for whom joint ventures are a serious option will need to provide for necessary flexibility in the drafting the high yield covenants and, after the fact, parse the indenture carefully when attempting to form a joint venture.

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 non-subsiary 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!).

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 the investment banks' 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.

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, however, can be specifically negotiated for as an acceptable alternative to a cash sale if there is a realistic possibility that these transactions may occur. 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 of 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.

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 often be defined to mean the approval of a majority of the directors who do not have an interest in the transaction.

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, limitations on sale-leasebacks, 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.

Conclusion

The high yield indenture is a complex and sometimes counterintuitive instrument. By its nature, it will be part of the portfolio company's capital structure for a long time, often for as long as the private equity spon-

sor remains in the investment. If for no other reason than that, it merits the full force of the private equity sponsors attention, for it truly is the "gift that keeps on giving" for years to come. Whether it will be giving the sponsor relief, or headaches, over that period depends on how successfully the indenture is negotiated in the first instance. ©

