The Credit Roundtable

THE VOICE OF THE BUYSIDE

Covenant White Paper 2.0

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The Credit Roundtable: Strengthening Bondholder Rights Through Shared Activism

The legal rights of both issuers and investors are determined by the underlying bond contract language for these covenants, and these legal rights can have meaningful economic impacts. In the bond world, the vast majority of these covenant protections are incurrence based – so a bond issuer is not typically required to maintain certain goals under their covenants. The covenants are disclosed in the offering documents for bonds, but it is the contract (Indenture) language that ultimately controls. Unfortunately, there remains a gap between investor expectations for covenant protections and the commercial reality of that language. Over time, changes to covenant language can make it even more difficult for investors to assess the gap between expectation and reality.

The Credit Roundtable[1] ("CRT") aims to align investor expectation with covenant reality. In 2007, the CRT published its White Paper, "Improving Covenant Protections in the Investment Grade Bond Market." This White Paper "1.0" proposed model covenants in an effort to fairly balance economic flexibility for issuers on the one hand and bondholder interests in covenant protections for their investment on the other hand.

The CRT now proposes Covenant White Paper 2.0. White Paper 2.0 again seeks to provide a fair balance in legal protections for investors on the one hand and issuer economic flexibility on the other (consistent with market practice). In addition to advocating for better covenant language, White Paper 2.0 looks to inform and to educate investors with respect to bond covenants, while providing updated model language to reflect current drafting.

White Paper 2.0 aims to highlight what investors should seek in covenant protections, while also addressing weaknesses and deficiencies in some existing language. While some of these covenants do not appear in the current investment grade bond market, the CRT believes that their inclusion would ultimately benefit investors as well as issuers, while simultaneously recognizing that bond investors alone cannot dictate covenant terms to the market.

[1] Formed in 2007, The Credit Roundtable ("CRT"), is a group of large institutional fixed income managers including investment advisors, insurance companies, pension funds, and mutual fund firms, responsible for investing more than $3.8 trillion of assets. The Credit Roundtable advocates for creditor rights through education and outreach and works to improve fixed income corporate actions, ineffective covenants, and the underwriting and distribution of corporate debt. Its mission is to improve risk assessment and management through education and seeks to benefit all bond market participants through increasing transparency, market efficiency, and liquidity.

The CRT recognizes that not all of the proposed covenants in White Paper 2.0 will be included in each investment grade bond transaction. Some of these features are more important in the split-rated and low "BBB" space than for the entire investment grade bond market. However, as investors who have seen covenant protections deteriorate over time as the credit cycle develops, the CRT believes that a return to more sensible covenant protections, updated for modern drafting, is appropriate as proposed in this White Paper 2.0

Broadly speaking, these Proposed Model Covenants have the following concern. They address:

- Transformative change of an issuer (Change of Control; Mergers; Material Asset Dispositions)
- Priming / subordination to new debt (Liens; Subsidiary Debt); and
- Disclosure (Reports)

This is a living document that sets forth model covenant provisions which may be tailored to the circumstances of particular issuers and particular market conditions and added to over time.

TRANSFORMATIVE CHANGES

Change of Control protection.

Why does Change of Control Protection Matter?

Bondholders should be able to reevaluate their investment decision when there is a significant change in the character of their corporate borrower, such as after an LBO.

Change of Control protection has become a fairly common and well-accepted feature of the corporate investment grade bond space. This is a success of White Paper 1.0, but there are areas of improvement possible. In White Paper 2.0, the proposed Change of Control language has been updated based on developments since the initial White Paper.

There remain a number of Change of Control provisions in the market where the investor put can be avoided based on a transactions legal structure, despite economic substance of the transaction remaining the same. For example, some Change of Control puts in the market are effective in a “reverse triangular merger” acquisition structure but would not be effective in a “parent to parent” public company acquisition context. White Paper 2.0 aims to limit these circumstances, through the inclusion of an independent “mergers” trigger and the narrowing of the “holding company exception.” This should reduce the circumstances in which the legal form of a transaction outweighs the economic substance when determining whether or not there is a Change of Control put right.

Market practice is to include a ratings trigger for a Change of Control put right, and that is retained in the Proposed Model Covenant. However, the rating condition drafting can vary, with unanticipated results. White Paper 2.0 provides model language to address the rating condition and match investor expectation to legal language. It also departs from White Paper 1.0 language, so that the rating condition would not be limited only to “crossover” rating events but could still be triggered in a split-rated or fallen angel situation.

The so-called “holding company exception” is retained for the White Paper 2.0 model language, but its scope is reduced and so less subject to abuse than current market standard.

The White Paper 2.0 proposes to change language as a result of case law that has developed since White Paper 1.0. Specifically on this point, the “continuing directors” trigger has been eliminated from the model form as a result of case law precedent.

Finally, the White Paper 2.0 uses a flat 101 price for Change of Control offers. The CRT believes however that a different pricing mechanism may be more appropriate in the future – for example, a ratings-based coupon step-up provision.

Mergers and sales of assets

Why does a Mergers covenant matter?

The Mergers covenant is designed to provide a continuity of assets to which a bondholder can look. If "all or substantially all" of an issuer's consolidated assets are transferred, then the bond obligations should follow those assets.

The Mergers covenant and its related limitations on an issuer transferring "all or substantially all" of its assets is another critical covenant protection for bondholders. Although judicially interpreted as a boilerplate provision, a standardization of language would benefit all stakeholders. The White Paper 2.0 proposal provides a template example for such a provision. This provision is meant to capture both a series of related transactions that amount to a transfer of "substantially all" assets, as well as clarifying that the test is measured on a consolidated basis, and not just based on assets directly held by the Company. This aligns the Mergers covenant provisions with the Change of Control covenant.

How have bondholders been harmed by the Mergers covenant?

In a recent case, bondholders were harmed because a court ruled that the creation of new intermediate subsidiaries did not involve the transfer of "all or substantially all" assets. As a result of this ruling, bondholders (who benefitted from subsidiary guarantees) were subordinated to new guarantees from those intermediate subsidiaries.

Limitation on Material Asset Dispositions

Why does a Material Asset Dispositions covenant matter?

This Limitation on Material Asset Dispositions covenant matters because current investment grade bond indentures do not provide adequate protection to bond investors for transformative asset sales that do not rise to the "all or substantially all" threshold. The CRT believes that the inclusion of a Material Asset Disposition concept will improve bondholder expense without unduly limiting issuer flexibility.

How can bondholders be harmed?

If there is no Material Asset Disposition covenant, then the fundamental character of the borrower can change with no recourse for bond investors. Issuers would be unwilling to accept a default remedy in the current market, so the Model Provision instead proposes a stepped-up interest payment as a result of Material Asset Dispositions.

Material Carveouts & Comments

Ratings based exception

If prior to any Asset Disposition that would cause the Material Asset Disposition Threshold to be exceeded, Moody's, S&P, and Fitch confirm the long-term debt ratings of the Notes, then such Asset Disposition will be disregarded for purposes of the foregoing limitations.

Certain dispositions disregarded

Certain ordinary course transactions are omitted from the scope of the Asset Disposition definition, preserving flexibility for an issuer in avoiding any covenant issues on "technical" grounds.

SUBORDINATION & PRIMING

Limitations on Secured Debt

Why does a Liens covenant matter?

A properly drafted Liens covenant limits the amount of secured debt that can come ahead of the Notes. When secured debt is raised without sharing the Lien with the Notes, the value of the Notes is impaired because they will not recover against the assets pledged to secure that debt. The amount of this secured debt should be knowable by bond investors, and not obscured by technical language.

A Liens covenant in an investment grade bond indenture provides limitations around an issuer issuing secured debt. A "true" Liens covenant limits the overall secured debt capacity for an issuer. A "negative pledge" Liens covenant limits the amount of secured debt that can be raised without equally and ratably securing the Notes. In either formulation, this is an important protection for investors. Without this limitation, or negative pledge, unsecured bond investors face a lower claim in an issuer's assets, which would likely reduce their recovery in the event of default or restructuring. This is often referred to as "getting primed".

White Paper 1.0 advocated for a "true" Liens covenant, that limited the amount of overall secured debt an issuer could raise. This has not been the prevailing market standard, however. Accordingly, White Paper 2.0 provides a model "negative pledge" covenant. While still allowing dilution (because of the equal and ratable provision), this model language eliminates many of the definitions and carveouts that provide unexpected capacity in favor of a flexible standard that is clearer for investors.

Specifically, many investment grade bond indentures apply only to "Restricted Subsidiaries." "Unrestricted Subsidiaries" sit outside of the covenant's reach and can freely pledge assets to secure debt. The model provision instead applies broadly to all subsidiaries.

The types of assets that can be pledged are also clearer in the model provision. There is no "Principal Property" type concept, because that antiquated idea often doesn't capture an issuer's assets, such as intellectual property as opposed to physical property, and also investors cannot reasonably determine what is and is not a Principal Property. Instead, the model provision applies broadly to a pledge of any property or assets of the Issuer and its subsidiaries to secure debt.

There is no requirement for a standalone Sale / Leaseback covenant for the model language, because the "Indebtedness" definition on which it turns captures the Attributable Debt of a sale / leaseback.

A typical Liens covenant will include a list of "Permitted Liens" carveouts. The White Paper 2.0 provides model language for two of the most important carveouts, the general secured debt carveout and the refinancing debt carveout. The general secured debt carveout includes a secured leverage ratio component which is uncommon in investment grade bond Indentures but does better reflect economic reality than the more typical "Consolidated Net Tangible Assets" formulation which is included as an alternative to the ratio. The ratio here is meant to be discernible and transparent for investors.

The covenant applies not only to subsidiaries of the Issuer, but to Guarantors, which can include a Parent Guarantor. Finally, whenever possible an issuer should provide some estimate of raising secured debt ahead of the Notes.

Have bondholders been harmed by existing Liens covenant language?

An investor may be unable to determine secured debt capacity when the protection is undermined by loose definitions. For example, an issuer pledged all assets to secure debt under its revolving credit facility to the maximum amount available under the general secured debt carveout for its Notes (so the Notes did not have to be equally and ratably secured with the revolver). This carveout was to a typical 15% of Consolidated Net Tangible Assets. Separately, a term loan was secured by an extremely valuable offshore asset. Because this asset was not a "Principal Property", the transaction did not implicate the Liens covenant, and the Notes were not equally and ratably secured.

Material Carveouts: & Considerations

General secured debt carveout

This is the principal source of capacity available for issuers to raise secured debt without having to equally and ratably secure the Notes. Historically this was a straight balance sheet calculation. White Paper 2.0 embraces alternative basket calculations, as issuer capacity should be able to change with business circumstances. Further, the traditional "Net Tangible Assets" test has been replaced with a "Net Total Assets" metric to reflect modern balance sheets.

In addition to a general secured debt carveout, consideration should be given as to whether there should be an independent carveout for Credit Agreement debt. If such a separate carveout is added, then it is imperative that a cap be placed on the amount of debt that can be raised under that carveout.

Refinancing debt carveout

The refinancing debt carveout should allow existing secured debt to be refinanced when due into new secured debt. However, the carveout needs limits to avoid abuse: the amount of debt that can be raised in the refinancing, the maturity of the new debt, and the assets pledged to secure the new debt must all be limited.

Acquisition debt carveout

Acquisition debt carveouts allow secured debt to be raised for the purposes of acquisitions. This is an appropriate exception to the general rule but requires some drafting limitations to avoid abuse. The carveout should be limited so that the lien securing debt attaches only to properties and assets of the acquisition target, and not to existing properties and assets of the Company and its subsidiaries.

Receivables carveout

Pledging inventory and receivables would be captured by the Model Liens covenant. This carveout appropriately allows receivables to be pledged, but there should be limits on the types of assets that can be pledged and the amount of debt that can be raised.

Limited Condition Transactions

Limited Condition Transaction calculation rules apply. For certain types of transactions, the Company can test compliance under the covenant on an earlier date to ensure that it will be permitted at some future date.

EBITDA Calculation note

The Consolidated EBITDA definition underlying the Leverage Ratio is based on Regulation S-X. This would align investor expectations for EBITDA with covenant EBITDA. The market however has moved away from this approach and towards a more generous add-back approach. To the extent an alternat EBITDA definition is used, there should be aggregate caps on add-backs, and those calculations should be made before adjustments, not after.

Limitations on Subsidiary Indebtedness

Why is a Limitation on Subsidiary Debt needed?

A Subsidiary Debt covenant is concerned with the amount of structurally senior debt that non-guarantor subsidiaries can raise. Together with the Liens covenant, this affords bondholders a degree of protection against priority debt.

White Paper 1.0 observed the increasing use of structurally senior debt of non-guarantor subsidiaries to prime existing unsecured bonds with respect to those subsidiary's assets in LBO transactions. These "priming" transactions now not only appear in LBO financings, but in other corporate actions that harm bondholders. White Paper 1.0's proposal of a limitation on priority debt is the correct idea but lacks market implementation.

Still, a straightforward and understandable limit on structurally senior debt (i.e., debt of non-guarantor subsidiaries) should be included in every BBB investment grade bond transaction, and even in transactions involving higher rated companies as their rating may migrate down over time. This Model Covenant doesn't limit overall subsidiary debt but does limit the amount of structurally senior debt non-guarantor subsidiaries can incur or guarantee – that is, it preserves issuer flexibility while providing some protection for bondholders' relative ranking. It also has the advantage of having appeared in the market. Carveouts can be specifically negotiated to allow non-guarantor subsidiary debt on a case-by-case basis.

How can a Subsidiary Debt covenant harm bondholders?

It is the absence of this provision that harms bondholders, allowing non-guarantor subsidiaries uncapped ability to raise debt that would be structurally senior to the Notes with respect to that subsidiary's assets. Subsidiary guarantees included through this covenant could determine the outcome for bonds in a leveraged buyout scenario.

Material Carveouts

General Subsidiary debt basket

This carveout should be shared with the Liens covenant – and so achieve a similar goal to the White Paper 1.0 objective of limiting priority debt. The general basket being shared between subsidiary debt and secured debt creates this capacity for priority debt.

Refinancing debt basket

This carveout should allow subsidiary debt to be refinanced, if the maturity is not shortened and the obligor structure does not change for the refinanced debt.

<u>DISCLOSURE</u>
<u>Reporting obligations.</u>

Why is a Reporting covenant needed?

A proper Reports covenant's goal is to ensure continued information that allows lenders to evaluate their investment through its entire duration, regardless of any changes in Exchange Act status.

The risk of issuers "going dark" after suspension of SEC Exchange Act reporting obligations remains for bondholders – and this risk has been exacerbated since publication of White Paper 1.0 as it has become clear that the Trust Indenture Act does not separately require reporting.

Transparent financial information for the life of a bond's maturity is a critical component of the investment decision. Issuers that benefitted from the public markets and their disclosure regime should have some obligation for future disclosures for the life of the securities. Most investment grade bond indentures simply recite the underlying Trust Indenture Act reporting obligation — which, absent SEC action, does not impose a requirement to provide financials if the Company is no longer an Exchange Act filer. This is another plain English disclosure issue — because a plain reading of the Trust Indenture Act language, imported into many investment grade issuers, would seem to include an ongoing reporting obligation However, due to a lack of SEC action, there is in fact no continuing reporting obligation.

The White Paper 2.0 proposes an independent reporting obligation that will continue even if the Issuer is no longer an Exchange Act filer. This obligation is not meant to be unduly onerous on issuers, and so it can be satisfied by a parent entity's financial statements under certain circumstances as well. One further consideration would be financial consequences for failure to comply with the Reports covenant, in place of a default / acceleration remedy.

How have reporting covenants been abused?

In 2018 an American pipeline company was acquired by a Canadian entity. The acquisition allowed the American issuer to deregister its securities, and the Reports covenant for the issuer's bonds did not require continued reporting if the issuer no longer had Exchange Act registered securities.

What is the appropriate remedy for a failure to file timely reports?

The CRT believes that increased interest should be required for a failure to timely file reports, rather than a default / acceleration remedy.