High-yield bond covenants: views from across the ocean

High-yield (HY) bonds issued in the European or US markets are generally similar: they are typically New York law-governed with a similar framework of covenants, including restrictions on an issuer group's ability to incur further debt, pay dividends, make investments, transact with affiliates and sell assets outside the ordinary course of business.

Increasingly, European HY issuers are issuing bonds in dollars in the US market and US HY issuers are issuing bonds in euros in the European market, with these "Yankee" and "Reverse Yankee" bonds surging to a combined total of $54.1 billion in the first half of 2017; a four-fold increase compared to the first half of 2016. In 2017, a record number of US issuers, both in value and volume, have placed bonds in Europe.

Imported from the US more than two decades ago, the European HY bond, while similar in most respects to its US counterpart, has diverged in a number of subtle but important ways. An understanding of some of the key differences between the US and European markets is important as more issuers look across the Atlantic to raise funds.

Market dynamics

Historical and market trends in Europe and the US have changed the HY bond products that are typically available to issuers.

Secured bonds. The European market recently has had a larger proportion of senior secured issues than the US market, based on current data. Generally, just under half of all European issues are secured, compared to about a quarter in the US. The prevalence of secured issues in Europe makes certain indenture terms, such as the ability to redeem 10% of the aggregate principal amount of the bonds outstanding at a price of 103% of the principal amount, and a ratio for determining the maximum amount of first lien debt, more common in Europe than in the US.

Direct lending. Direct lending occurs when financial institutions other than traditional investment banks, usually private equity firms, offer to directly purchase or underwrite the debt of an issuer without involving a traditional arranger. Although direct lending in the US constitutes a more significant portion of sub-investment grade debt issues when compared to the European market, direct lenders are making inroads into the European market and this process is likely to accelerate in the near future with the European Central Bank announcing final guidelines on leveraged lending due to take effect in November 2017 (the guidelines) (*www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170516.en.html*).

The guidelines will affect internal procedures for lending that exceeds a certain leverage ratio issued by regulated institutions such as investment banks. Similar leveraged lending guidelines published in the US in 2013 have been credited with expanding the direct lending market.

SEC registration. Historically, US HY bonds were either registered with the US Securities and Exchange Commission (SEC) or subject to bondholder registration rights, where the bonds would be exchanged shortly after issue for identical SEC-registered bonds. This is done to remove resale restrictions that are otherwise applicable to unregistered US HY bonds and to help with marketing the bonds, as some US investors prefer, or are required by their organisational documents, to invest in SEC-registered bonds. The US market has seen a decline in SEC registration rights in recent years, with bonds with no registration rights (so-called "144A for life") becoming more popular, but SEC registration for US HY bonds is still somewhat common and an important distinguishing feature from European HY bonds.

When bonds are registered with the SEC, they must be issued under an indenture qualified under the US Trust Indenture Act of 1939 (TIA). The TIA imposes certain requirements on the indenture, including limiting the issuer's ability to impair or affect a bondholder's right to receive payment of the principal of, and interest on, its bonds. If those provisions are not part of the indenture, they apply as a matter of law. In TIA qualified indentures, unanimous bondholder consent is required to change fundamental rights, whereas in European deals, typically just 90% of bondholders are required to consent to similar changes. Recent litigation in the US involving the TIA has led to an increasing number of 144A for life bonds, as the application of the TIA created uncertainty around the issuer's obligations.

Until the early 2000s, the practice of issuing HY bonds with SEC registration rights was also a part of the European market. Subsequently, the practice has effectively ceased, as European investors are happy to rely on reporting covenants in the HY bond indenture without SEC registration and reporting obligations.

Listing of bonds. HY bonds issued in Europe are typically listed on a stock exchange. Bonds generally do not trade in any significant volumes, but rather they are listed to help ensure the availability of an exemption from withholding tax and because many investors prefer to hold bonds that are listed on a stock exchange, similar to the US investor preference for SEC-registered bonds. Traditionally, the unregulated markets in Luxembourg and Ireland were the stock exchanges of choice for European HY bond issuers.

The Market Abuse Regulation (*596/2014/EU*) (MAR) imposes additional disclosure obligations on any security, including bonds, listed on an exchange within the EU, including on unregulated markets such as the Luxembourg and Irish stock exchanges (*see feature article "Market Abuse Regulation: ensuring compliance amidst uncertainty", www.practicallaw.com/6-629-5677*). MAR includes a number of new disclosure requirements on issuers of HY bonds listed on an EU stock exchange, including the immediate disclosure of material information, requirements to maintain insider lists, and limits on sharing confidential information. These rules have also affected the ability to pre-market capital raises to investors without publicly disclosing the possibility of a capital raise.

However, MAR does not extend to listings on non-EU stock exchanges, so some issuers are listing bonds on stock exchanges such as the Channel Islands Securities Exchange to avoid its application. Despite this trend, MAR still regulates most legacy issuers.

Covenants

The differences in historic trends, market dynamics and investor preferences between the US and European markets have also led to differences in specific covenants in US and European HY bonds.

Acquired debt. The debt covenant of a typical HY bond limits the debt of the issuer group, subject to permitted debt exceptions. One customary exception is for acquired debt, which permits the incurrence of target company debt when an acquired company becomes part of the issuer's group, provided that either:

- The issuer meets the general ratio test, which is typically a 2:1 EBITDA (earnings before interest, taxation, depreciation and amortisation, with adjustments) to interest ratio, assuming the effect of completing of the acquisition.

- The ratio following the acquisition is either the same or improves.

However, in some US issues, particularly US sponsor deals such as HY bonds issued by private equity portfolio companies, issuers have been able to incur unlimited debt from an acquired target, provided that it was not incurred in contemplation of the acquisition, regardless of the debt incurrence ratio.

Acquisition debt. The same exception that permits acquired debt also typically permits acquisition debt, or debt incurred in connection with the acquisition of a new company in the issuer's group, where, as with acquired debt, the issuer meets a general ratio test for debt incurrence, or the ratio following the acquisition is the same or improves. In some US deals, issuers that fail to meet either ratio test can instead rely on a basket capped at the greater of a percentage of EBITDA or assets and a fixed dollar amount, which is not common in Europe. The flexibility offered by the evolution of these debt exceptions in the US provides issuers with additional options when assessing a potential target with substantial debt.

Synergies. The calculation of EBITDA is important in a HY indenture, as it forms the basis of general debt incurrence capacity (in a minimum interest coverage or a maximum leverage test), which in many cases needs to be met for the payment of dividends, and secured debt capacity (the maximum secured leverage test). It is also important because it is often used as the basis to increase the size of basket exceptions from the indenture covenants for soft-capped baskets (that is, baskets capped at the greater of a fixed amount and a percentage of EBITDA), including permitted debt baskets and restricted payments baskets, such as for dividends and investments.

The definition of EBITDA in bond covenants typically differs from the technical definition of EBITDA because it adjusts for items other than just interest, taxes, depreciation and amortisation. To the extent that adjustments increase EBITDA, this increases the issuer's debt capacity, including secured debt capacity, and therefore, the size of basket exceptions to covenants in the indenture, including dividend baskets.

One important adjustment to EBITDA in many indentures is to add back to EBITDA sums to reflect anticipated savings and synergies resulting from an acquisition. In Europe, an issuer can often add back uncapped sums in calculating its EBITDA, making it easier for the issuer to incur additional debt, including debt used to finance the acquisition, as well as reducing the likelihood that an issuer will have to make a change of control offer if a leverage-based portability exception is available (*see "Limits of convergence" below*).

In the US, the amount of these anticipated savings that can be added back is usually capped at a certain percentage or time limited, meaning that the synergies must be reasonably anticipated to arise within a certain period of time. However, the trend in the US has been towards increasing flexibility in this area. EBITDA add-backs for cost savings and, in some cases, uncapped add-backs for synergies are becoming more common in the US, while the time limits are growing longer and there have been a few US sponsor deals with no time limit at all, as is customary in European HY deals. In this sense, the US market is converging toward the European practice.

Covenant suspension. HY bonds are usually rated well below investment grade, but bond indentures (for both US and European HY issuers) typically provide that, on reaching investment grade status, most of the restrictive covenants are suspended. The covenants will apply again if the rating falls below investment grade. Most US deals require that in order for the covenants to be suspended, the bonds need to be rated investment grade by two rating agencies, but in a few cases, particularly US sponsor deals, an investment grade rating is required from only one rating agency. The European practice still typically requires two rating agencies.

Increasingly, US issuers' covenants permanently fall away if the bonds become investment grade, while this remains rare in Europe. Furthermore, the US market has been more accepting than the European market of covenant suspension generally, allowing more covenants to be suspended, such as change of control seen in a few recent deals. In European HY deals, the practice is limited more narrowly to the suspension of covenants such as the limitation on debt and restricted payments.

EBITDA-growers. In both jurisdictions, the exceptions to the general limitations in covenants are in the form of baskets, so an issuer can incur debt or make restricted payments up to the amount of the basket, and many covenants also do not apply to transactions below de minimis thresholds. Baskets and de minimis thresholds are usually capped at the greater of a specific amount in dollars or euros and a percentage of total assets, known as soft-capped or grower baskets.

Soft-capping of baskets and thresholds by reference to EBITDA, rather than total assets, has become a feature of many European bonds over the past couple of years. In the US, baskets like the restricted payments starter baskets (*see below*), debt incurrence baskets and lien baskets are increasingly using soft-capped baskets tied to EBITDA, but those terms are not as prevalent as in Europe.

Limits of convergence

In 2015, there was an apparent trend where differing practice in the European and US markets seemed to be converging rapidly (*see Briefing "High-yield bond provisions: crossing the Atlantic", www.practicallaw.com/9-601-2865*). In the past two and a half years, several of these key differences remain and the trend towards convergence seems to have stalled.

Change of control portability. US and European HY bonds both typically require the issuer to make an offer to repurchase the bonds on a change of control event. In Europe, many bonds provide that the issuer does not have to make a change of control offer on a change of control if it meets a leverage test, known as leverage-based portability. In some US deals, in particular in sponsor deals, issuers have double-trigger exceptions to their change of control provision; that is, where an issuer will not have to make the change of control offer on a change of control if there is no ratings decline. Although in the past few years there have been a handful of US offerings with leverage-based portability and European offerings with a US investment grade-style double-trigger change of control covenant, neither market has shown signs of converging.

Restricted payments starter baskets. In most HY bonds, an issuer can make restricted payments out of restricted payment build-up or reserve, which starts from 50% of its consolidated net income from the beginning of the quarter preceding or following the bond issue date minus 100% of its losses. In the US, however, some issuers will have a fixed dollar amount starter basket and, recently, soft-capped baskets tied to EBITDA, from which they can immediately make restricted payments. After a few instances in 2014 and 2015, starter baskets have remained rare in Europe.

Affiliate transaction fairness opinions. Transactions between the issuer and its affiliates, such as significant shareholders, are typically required to be on arms-length terms, with those above a certain threshold requiring board approval and, in some cases, a fairness opinion from an investment bank. However, in the US the requirement for a fairness opinion is no longer market practice. In 2014 and 2015, there were some indications that Europe might follow the US, but this appears to have stalled and requiring a fairness opinion remains relatively common in the European market.

James A McDonald, Michelle Gasaway and Michael Zeidel are partners, and Riley Graebner, Sarah Knapp, Lilit Kazangyan and Travis Walden are associates, at Skadden, Arps, Slate, Meagher & Flom LLP. The views expressed in this article are not necessarily those of Skadden, Arps, Slate, Meagher & Flom LLP or any one or more of its clients.