High-Yield Bonds in Asia

The Complete Issuer's Guide (Second Edition)

High-Yield Bonds in Asia

The Complete Issuer's Guide (Second Edition)

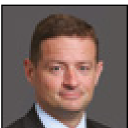
This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The publication is intended to provide a general guide to the subject matter and is not intended to provide legal advice or be a substitute for specific advice concerning individual situations. Readers should seek legal advice before taking any action with respect to the matters discussed in this publication.

With a vibrancy and diversity consistent with its many constituent countries and cultures, the Asian high-yield debt capital markets have expanded dramatically since the Asian financial crisis of the late 1990s. Credit investors in search of yield have gravitated toward the Asian high-yield market and issuance volumes have surged to record levels. In addition to deepening investor interest, the increased stability of after-issuance trading markets and the emergence of numerous repeat issuers, we have observed new business sectors, and even countries, accessing the high-yield markets as the overall Asia-Pacific high-yield market has matured.

Since our initial publication of this Guide in 2015, the high-yield market in Asia has continued to evolve and mature, supported by recent longer periods of lower volatility and more consistent investor demand. Changes have continued with respect to deal structures and covenant packages designed to suit new issuers and developing markets. Despite this changing landscape, the core high-yield principles and structures remain present while innovations from the deeper U.S. and European high-yield markets continue to be imported for application in Asia.

This Guide addresses the core elements of high-yield debt as they have been tailored to fit Asia-based issuers. We have attempted to provide existing and new issuers with a reference tool to help understand and navigate high-yield covenant packages, structures and deal execution in Asia. In addition, we hope that this Guide will better equip issuers to manage their indenture compliance analysis post-issuance.

Thank you for your interest in this new edition. We trust that it will be a key resource for new and existing issuers in the Asian high-yield markets, and we hope that you will find it useful for your business.



Jason T. Elder
Registered Foreign Consultant (New York)
Partner, Mayer Brown LLP

Thomas Kollar
Partner, Mayer Brown LLP

Contents

High-Yield in Context 1

High-Yield Bonds Compared to Traditional Bank Financing 1

The Ideal High-Yield Bond Candidate 4

The Credit Group and Building the Credit Story 4

The Issuer 5

Subsidiaries: Restricted and Unrestricted 6

The Guarantors 7

General Observations 9

Overall Objective and Process of Negotiating a High-Yield Covenant Package 9

"Incurrence" vs. "Maintenance" Covenants 10

Baskets 11

Duration of Covenant Restrictions 12

Subordination 13

Contractual Subordination 13

Structural Subordination 14

Lien Subordination 15

Redemption Features 16

The High-Yield Bond Covenant Package 18

Limitation on Indebtedness 18

The Exemption for "Ratio Debt" 20

Limitation on Indebtedness: Basic Illustrations 22

The Permitted Debt Exemption 23

Availability of Exemptions 25

Other Covenants to Consider 26

Limitation on Restricted Payments 27

Definition of Restricted Payments 30

Calculation of the Net Income Basket 31

Restricted Payments Calculation: An Example 32

Restricted Payments: Basic Illustrations 33

Conditions to Using the Net Income Basket 34

Permitted Restricted Payments 34

Permitted Investments 35

Availability of Exceptions 36

Other Covenants to Consider 36

Limitation on Dividends and Other Payments from Restricted Subsidiaries 37

Other Covenants to Consider 38

Limitation on Liens 38

Other Covenants to Consider 39

Limitation on Sales of Assets and Subsidiary Stock 39

Limitation on Affiliate Transactions 44

Limitation on Designation of Restricted and Unrestricted Subsidiaries 45

Limitation on Merger, Consolidation and Sale of Substantially All Assets 47

Change of Control 48

Reporting Requirements 49

Limitation on Business Activities 50

Limitation on Issuances of Guarantees of Indebtedness 51

Use of Proceeds 51

Payments for Consent 51

Global Comparison of High-Yield Bond Covenant Packages 52

A Closer Look at High-Yield Bonds for Asia-Based Issuers 62

General Considerations for Asia-Based Issuers 62

Currency 62

Rating Enhancements 62

Offering Type 63

Key Considerations for Offerings by PRC Issuers 63
Credit Support and Structural Subordination 63
Security 64
Covenant Package 64
Key Considerations for Offerings by Indonesian Issuers 64
Withholding Tax 64
Singapore Tax Implications 67
Indonesia Tax Implications 68
Material Transactions 68
Security 69

Legal Considerations 70
Governing Law 70
Transaction Structure and U.S. Federal Securities Law 70
Section 4(a)(2) 71
Rule 144(A) 71
Regulation S 72
Registered Exchange Offers Versus Private-For-Life 75
Publicity Restrictions 77

Transaction Execution 79
Pre-Launch 79
The Due Diligence Review 82
General Guidelines 82
Conducting Due Diligence 82
"Rule 10b-5 Letter" 83
Documentation 84
Offering Memorandum 84
Indenture 88
Purchase Agreement 89
Intercreditor Agreement 89
Legal Opinions and Disclosure Letters 89
Comfort Letters 90
Post-Launch 90

High-Yield Bonds Compared to Traditional Bank Financing

High-yield bonds (or notes) provide companies with the benefits associated with long-term debt financing but with covenants that are typically less onerous than standard credit facility covenants. In addition, the covenant package can be self-administered rather than requiring an ongoing dialogue with creditors or regular inspections by a bank lender. The high-yield bond covenant package largely does not include traditional bank financing maintenance covenants, which require that the Issuer maintain a certain financial health or the lenders can call or accelerate the loans. Instead, the high-yield covenant package includes incurrence covenants, which are evaluated only when the Issuer (or any of its Restricted Subsidiaries) seeks to take some action such as incurring indebtedness, paying a dividend or making an investment.

The high-yield covenant package rewards positive financial performance with additional flexibility, while poor financial results reduce flexibility to protect investors but does not cause a default or acceleration by itself.

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

As a whole, the high-yield covenant package has been designed to (i) prevent the Credit Group (consisting of the Issuer, any Guarantors and all Restricted Subsidiaries) from becoming over-leveraged by either borrowing too much or decreasing its cash-generating assets without concurrently decreasing its debt, (ii) protect the position of noteholders in the Credit Group's capital structure by limiting the ability of the Credit Group to effectively subordinate the bonds through structural or lien subordination and (iii) preserve the assets of the Credit Group and the Issuer's access to such assets. Through the covenant package, positive cash flow is preserved for debt service while transactions that could deplete assets of the Credit Group are monitored to prevent deterioration of the assets producing such cash flow. Moreover, such covenants are designed to scale with the Issuer's business as it grows in size over the lifetime of the bonds.

High-yield covenants place restrictions (with numerous carve-outs that will be discussed later) on the ability of the Credit Group to:

- incur debt;
- declare or pay dividends, invest outside the Credit Group or make certain other restricted payments that would result in value leakage out of the Credit Group;
- grant security interests over its assets (securing indebtedness other than the bonds);
- sell assets and the capital stock of subsidiaries;
- enter into affiliate transactions;
- issue guarantees of debt incurred by others;
- engage in mergers or consolidations or sell substantially all of the Issuer's or a Guarantor's assets;
- enter into new types of business activities;
- enter into transactions that would fundamentally alter the ownership structure of the credit group; and
- agree to restrictions on distributions and transfers of assets within the Credit Group.

The Ideal High-Yield Bond Candidate

High-yield bond issuers are typically (i) established companies without investment-grade ratings, (ii) private companies looking to reorganize their capital structures or (iii) companies that are the targets of a leveraged buyout financing. A high-yield issuer exhibits some or all of the following characteristics:

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

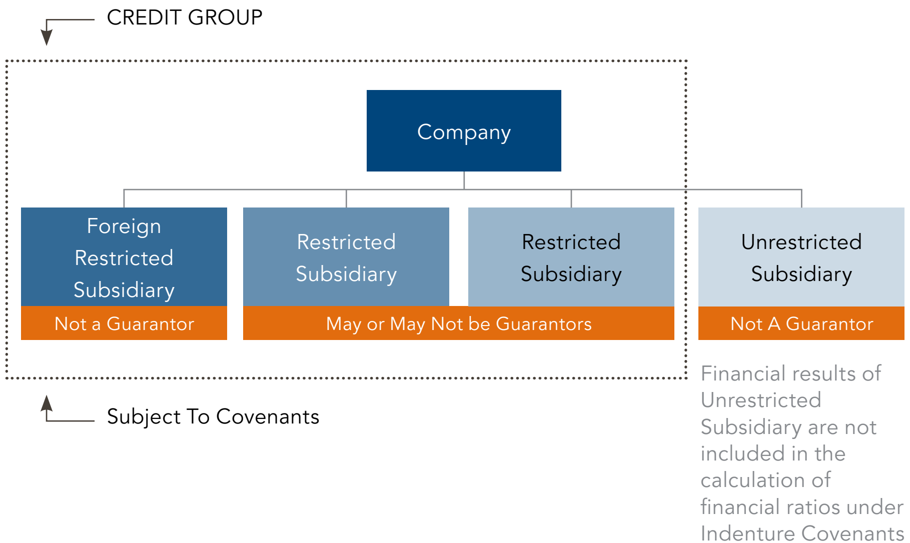
PRACTICE TIP

The typical Asian high-yield covenant package is, in many ways, stronger than the customary U.S. and European covenant packages, thereby addressing enforcement challenges (and numerous negative enforcement experiences) in certain Asian jurisdictions post-default.

The Credit Group and Building the Credit Story

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

The Issuer, any Guarantors and all Restricted Subsidiaries constitute the "**Credit Group**" and fall within what is sometimes referred to as "the box." Only the entities comprising the Credit Group (in other words, only those entities sitting within the box) are subject to the covenant package. The covenants aim to protect the noteholders from diminution in the assets and creditworthiness of the Credit Group during the lifetime of the bonds. The financial strength and asset quality of the Credit Group form the basis of the credit story presented to investors and rating agencies, and ultimately impact the marketability and pricing of the bonds. Set forth below is an illustration of a typical Credit Group with the dotted line indicating "the box:"



The Issuer

The selection of the entity to act as the issuer of the bonds depends on a variety of factors such as the capital structure of the company and any existing senior debt permitted under its current obligations. However, the high-yield product encourages holding company ("**HoldCo**") financing with free movement of cash flows from subsidiaries to the HoldCo and vice-versa. The issuance structure matches neatly against the holding structure for many Asia-based issuers, where the offshore HoldCo will serve as the issuance vehicle with onshore operating subsidiaries deploying the proceeds from the offering.

Although technically the issuance vehicle could be either the ultimate parent holding company, an intermediate operating holding company or a lower level operating company, the Parent holding company will typically serve as the issuer. This decision will raise important tax considerations and, for certain jurisdictions, these tax considerations will be so considerable as to drive issuance structures. The classic example would be structures used by Indonesian issuers. See *A Closer Look at High-Yield Bonds by Asia-Based Issuers — Key Considerations for Offerings by Indonesian Issuers*.

Subsidiaries: Restricted and Unrestricted

The covenant package classifies all subsidiaries as either Restricted Subsidiaries or Unrestricted Subsidiaries. Restricted Subsidiaries are bound by the covenant package, which protects positive cash flow to service the bonds. Unless expressly designated as Unrestricted Subsidiaries, all subsidiaries of the issuer would be classified as Restricted Subsidiaries, meaning that their activities are subject to and limited by the covenant package contained in the indenture governing the notes. For a first-time issuer, there needs to be a good reason to exclude a subsidiary from the Credit Group. For Asia-based issuers, a classic example of a subsidiary to exclude would be a new project company, which has not yet become cash flow positive. This entity would not be directly relevant to investors on the issuance date because its cash flow isn't supporting the credit story and its assets are likely pledged to third-party project lenders. Later, when the project has been completed and is operational, the Issuer might consider re-designating the project company as a Restricted Subsidiary so as to gain the benefit of its positive cash flow on various covenants in exchange for subjecting it to the limitations imposed by the covenant package. For a discussion of the limitations and process on re-designation, see *The High-Yield Bond Covenant Package — Limitation on Designation of Restricted and Unrestricted Subsidiaries*.

Returning to the Credit Group, however, it is important to consider things from the other perspective: what entities properly sit outside the Credit Group? Unrestricted Subsidiaries are, by definition, not part of the Credit Group and are not subject to the covenant package. This position means that they can incur unlimited amounts of debt (on a non-recourse basis to entities in the Credit Group) and engage in transactions without applying

the covenant package. This arm's-length relationship of an Unrestricted Subsidiary with the Credit Group will result in various impacts under the covenants, for example:

- the financial results of Unrestricted Subsidiaries are not included in the calculation of financial ratios under the covenants and therefore do not affect (positively or negatively) covenant compliance for the Credit Group; and
- intercompany transactions between Unrestricted Subsidiaries, on the one hand, and the Issuer and the Restricted Subsidiaries, on the other hand, are subject to greater limitations than those solely between and among Restricted Subsidiaries and the Issuer.

The high-yield covenant package seeks to limit activities by the Credit Group to avoid value being transferred outside the box and to prevent deteriorating credit actions when business performance declines. However, the Issuer may elect to grow new businesses outside the constraints of the bond covenants by forming Unrestricted Subsidiaries or re-designating Restricted Subsidiaries as Unrestricted Subsidiaries.

The Guarantors

High-yield bonds are frequently guaranteed by most, if not all, of the Issuer's Restricted Subsidiaries ("**Upstream Guarantees**"), and in secured offerings such Guarantors also typically provide asset security for the bonds. The Upstream Guarantees give noteholders a direct claim against the relevant Guarantor Subsidiaries and their assets in the event of default by the Issuer, which overcomes some structural subordination issues. See *General Observations — Subordination — Structural Subordination*. If the Issuer is an entity other than the ultimate parent company, there may also be a parent guarantee ("**Downstream Guarantee**") in order to provide additional financial support to its subsidiary issuer.

PRACTICE TIP

For investors in typical PRC high-yield structures, noteholders only receive subsidiary guarantees (and related share pledges) from non-PRC subsidiaries. In a default scenario, such structural subordination significantly limits noteholder access to onshore assets and places offshore creditors at a significant disadvantage to onshore lenders.

Often, however, a Restricted Subsidiary is required to guarantee the bonds only if it guarantees other debt of the Issuer and another Guarantor. In some jurisdictions, guarantees by foreign subsidiaries can have negative tax consequences and it is therefore necessary to consult tax specialists early in the structuring process. For example, foreign subsidiaries of U.S. issuers usually do not act as Guarantors because, under prevailing tax law, a guarantee by a foreign subsidiary of a U.S. parent company's debt is deemed a dividend, subject to certain exemptions. Additionally, in some jurisdictions, foreign subsidiaries simply cannot serve as guarantors due to regulatory hurdles or prohibitions related to such foreign subsidiary guaranteeing offshore debt.

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

General Observations

This section provides a high-level overview of some of the general principles of a high-yield covenant package.

Overall Objective and Process of Negotiating a High-Yield Covenant Package

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

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

The Issuer should consider and explore all reasonably foreseeable transactions and activities, during the structuring phase, that the Issuer may engage in while the bonds will be outstanding and that might be restricted under the covenants, including (i) future acquisitions, joint ventures or other investments, (ii) future financing plans and requirements (*e.g.*, equipment financing, sale and leaseback transactions, receivables financings or other secured debt transactions), (iii) debt or debt-like arrangements incurred in the ordinary course of business, (iv) plans for potential geographic expansion and/or new lines of business, (v) the need for letters of credit or other credit enhancements, particularly if required to conduct its business at the time the bonds are issued, (vi) expected intra-group funds flows and (vii) potential related party transactions. Through this exercise, the Issuer will gain a greater understanding of the functioning of the covenants themselves while also identifying ways in which its business differs from other similar companies in an industry or country.

As a practical matter, international legal counsel for the underwriters typically prepares the first draft of the "Description of the Notes" for the offering memorandum, which will closely track (largely verbatim) the relevant contractual provisions that will later be included in the indenture. Although the Issuer's international legal counsel will then take a leading role in "marking up" this initial draft, it is essential that senior management of the Issuer and its financing and accounting staff are closely involved in this process as outside counsel cannot be expected to anticipate all flexibility the Issuer may need over the life of the bonds.

"Incurrence" vs. "Maintenance" Covenants

Unlike a typical senior credit facility, a high-yield indenture will not include any so-called maintenance covenants that require the Credit Group to maintain or improve certain financial ratios or metrics over time. Maintenance covenants can be breached, not necessarily by the Issuer or its subsidiaries taking any affirmative action per se, but simply by the Issuer and its subsidiaries having poor operating or financial results. High-yield incurrence covenants will be triggered only upon the taking of certain actions, such as incurring additional indebtedness or making so-called Restricted Payments (as defined below). This key difference in approach

provides an advantage to issuers in a declining market (*e.g.*, when declining EBITDA causes leverage to increase) that might be caused by macroeconomic factors and not the direct consequence of management's business decisions.

Baskets

The Issuer's and each Restricted Subsidiary's ability to engage in certain types of transactions that are restricted by a particular covenant will often depend on the capacity available under so-called "baskets." "Basket" is a term used to describe the method by which the covenants define the capacity of the Credit Group to engage in certain types of activity restricted by a particular covenant. For example, the Limitation on Indebtedness Covenant may include several specified baskets denominated in the bond currency, including possibly a basket for local currency debt issued by foreign subsidiaries (for working capital purposes) and, most importantly, a basket for indebtedness issued under the Issuer's senior credit facilities.

Certain baskets may grow and may also become depleted over time (*e.g.*, baskets that are based on accumulated consolidated net income of the Issuer, reduced by the aggregate amount of Restricted Payments made, respectively, since the date of issuance of the bonds) and/or be "refillable," while other baskets may be "one-time only." The Issuer would obviously prefer to be able to refill baskets, for example, as indebtedness incurred under a particular basket is repaid, and refillable baskets have become more common. While many baskets are traditionally expressed as specified fixed amounts in the currency of the bonds, many transactions increasingly use "softcaps" that are expressed as the greater of a fixed amount and a percentage of, for example, total assets. These soft caps reward issuers for strong financial performance and provide them with flexibility for growth over the lifetime of the bonds.

In addition to specific baskets for specific categories of transactions, covenants may also contain a so-called "general" or "hell-or-high water" basket, which may, for example, permit a limited amount of indebtedness to be incurred for any reason or no reason at all. Issuers should guard this

basket carefully, as "hell-or-high water" events tend to occur far more frequently during the lifetime of the bonds than the parties normally expect at the outset. It is important that the Issuer preserve, as much as possible, the capacity available to it under the various baskets. This is because, as a general matter, it will always be more advantageous to the Issuer to designate a transaction as having taken place pursuant to a general (*i.e.*, a "non-dollar restricted basket") exemption to a covenant or pursuant to a basket designed for a specific category of transactions, rather than pursuant to a general basket.

Duration of Covenant Restrictions

Generally, the covenants will apply as long as the bonds are outstanding. While waivers and amendments under traditional senior credit facilities are relatively common and uncomplicated, waivers and amendments to high-yield bond indentures typically require the Issuer to solicit consents from a qualified majority of, or possibly all, noteholders, which can be costly and time-consuming.

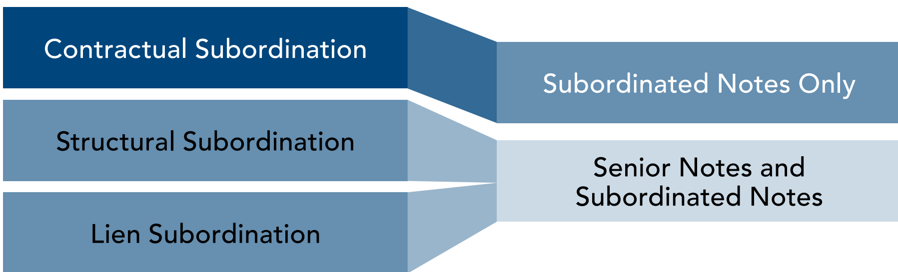
For high-yield debt issuers that are on the cusp of investment-grade, it is, however, possible to negotiate fall-away covenants or suspension covenants. Under fall-away covenants, if the Issuer's long-term debt receives an investment-grade rating from two out of three rating agencies, most of the high-yield covenants are automatically deemed eliminated (*i.e.*, they fall away forever) and only investment-grade covenants will remain. In a typical fall-away scenario, the remaining investment-grade covenants are: limitation on liens; limitation on merger, consolidation, and sale of substantially all assets; change of control covenant and reporting covenant.

Suspension covenants, however, are only in place while the Issuer is rated sub-investment grade. If the Issuer gains an investment-grade rating, such covenants are suspended. However, if the Issuer's investment-grade rating is lost, then the high-yield covenants will resume (meaning that the covenant package "springs" back into existence).

Subordination

High-yield bonds are sometimes structured to be junior to bank debt (*i.e.*, subordinated) because subordination allows the Issuer to incur debt more cost effectively than it could if all of its debt was senior. High-yield bonds can be either (i) expressly subordinated and referred to as subordinated notes or (ii) structurally subordinated and still referred to as senior notes.

The main types of subordination are contractual subordination, structural subordination and lien subordination. Only subordinated notes have express contractual subordination provisions, while structural and lien subordination may be a feature of both senior notes and subordinated notes.



Contractual Subordination

High-yield bonds are contractually subordinated when the debt is expressly subordinated by its own terms. Although a full discussion of the many issues raised by express subordination is beyond the scope of this Guide, under a typical subordinated high-yield bond structure, the subordinated noteholders agree that:

- upon the Issuer's bankruptcy or liquidation, they will not be paid until the senior debt is paid in full; and
- if any payment default of the senior debt has occurred and is continuing, any amounts received by the subordinated debt holders will be allocated to any senior debt holders until the senior debt is paid in full.

If any nonpayment default of the senior debt has occurred and is continuing, the subordinated notes become subject to payment blockage provisions in the indenture, whereby no payments are permitted to be made on subordinated debt for a specified period of time. Additionally,

the indenture will include standstill provisions, whereby the high-yield noteholders are required to give the senior lenders notice and wait for a certain period of time before accelerating the subordinated debt.

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

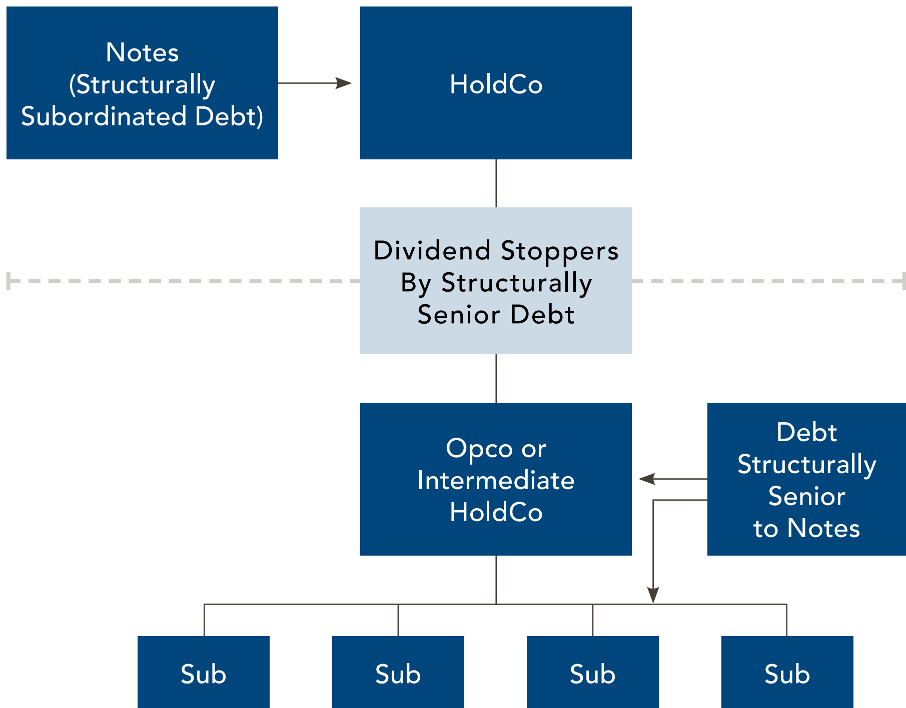
PRACTICE TIP

When reviewing other deals to determine what is "market precedent," it is important not to compare the covenants contained in a senior note indenture to the covenants in a subordinated note indenture or the covenants contained in a secured note indenture to an unsecured note indenture, as significant differences are to be expected. It is also a good practice to obtain precedents of other companies that are in the same industry of the Issuer, while unsecured senior note indentures will only allow a limited amount of other senior debt to be secured.

Structural Subordination

In the most common form of structural subordination, high-yield bonds are issued by a holding company without the benefit of any Upstream Guarantees. In this situation, structurally senior debt is issued by the operating company or subsidiaries where the operations and assets of the Issuer reside. The structurally senior debt may have restrictions on the ability of the operating company to make dividends and other payments to the Issuer holding company ("**Dividend Stoppers**").

The structurally subordinated notes are effectively junior in right of payment to the senior debt because Upstream Guarantees have not been provided by the operating company or its subsidiaries. As such, the operating company and its subsidiaries are not directly or indirectly obligated to make payments on the bonds. As a result, noteholders and



other creditors of the issuer holding company have no direct access to the assets or cash of the operating company and its subsidiaries. The only claim the issuer holding company creditors have on the assets of the operating company and its subsidiaries is through the equity of the operating company held by the issuer holding company (*i.e.*, the claim of an equity holder). In a bankruptcy or liquidation of the operating company, the claims of the issuer holding company's creditors would be junior to the claims of all creditors of the operating company and its subsidiaries, including the claims of unsecured creditors, such as subordinated debt holders and trade creditors.

Lien Subordination

For most non-investment-grade issuers, senior bank debt will often be secured by a first-priority lien on all or substantially all of the Issuer's and its subsidiaries' assets. High-yield bonds may be secured or unsecured. If secured, it can be either first-lien secured debt (in which case it is not

subordinated) or second-lien secured debt. If the bonds are first-lien secured debt, they will share the proceeds from collateral *pari passu* with the first-lien senior bank debt in the proceeds from collateral, while second-lien bonds will receive proceeds from collateral only after first-lien senior bank debt has been paid in full. However, in either case, the security interest of the high-yield bonds is generally silent, meaning the senior bank debt determines enforcement remedies with respect to the collateral. If the high-yield bonds are secured, an intercreditor agreement will set forth the rights and limitations as between the secured creditors with respect to the collateral. See *Documentation — Intercreditor Agreement*.

Redemption Features

High-yield bonds typically have three principal redemption mechanics: the "make-whole" redemption, optional redemption following a non-call period and the equity "clawback." As a general matter, redemption is limited during the early life of a new bond to provide investors with protection that their funds will not be returned shortly after the initial investment decision. Such early repayment would be financially burdensome for investors, especially after completing the credit analysis to evaluate the initial purchase. As such, the pricing terms make a redemption during the non-call period costly for the Issuer with greater flexibility being provided later in the life of the bonds.

The optional redemption period starts after an initial customary non-call period (*e.g.*, five years for seven-year bonds and three years for five-year bonds). The optional redemption pricing has been widely agreed by market participants as the principal amount plus accrued interest and a premium. The optional redemption premium steps-down from being equal to one-half of one year's interest payment in the first year that the bonds may be redeemed to a lesser percentage of the coupon rate in each year following the first year.

Prior to the end of the initial non-call period, the Issuer can redeem all or a portion of the bonds, but must pay a "make-whole" premium. This premium represents the principal amount being repurchased plus accrued interest and the amount of all interest payments due on the bonds through the optional redemption date, plus the first call premium. In other words,

the “make-whole” premium prices the redemption as though it were occurring on the first day of the optional redemption period, and thereby typically represents a costly option for the Issuer.

Within the first three years after the issuance date, the equity “clawback” feature enables the Issuer to redeem up to 35% of the bonds using the proceeds of certain equity offerings by the Issuer. The redemption price for the equity “clawback” is typically set at the principal amount, plus accrued interest, plus a premium equal to one year’s interest payment. The equity “clawback” feature will contain a requirement that not less than 65% of the bonds remain outstanding following the exercise of the equity “clawback” (in the case of a 35% redemption allowance), so any earlier repurchases or redemptions will act to reduce the available redemption amounts.

The High-Yield Bond Covenant Package

This section provides a high-level overview of the most significant high-yield bond covenants. The actual terms of the bonds will be described in a detailed "Description of the Notes" section in the offering memorandum that will be prepared for the offering. The covenants reviewed are applicable to unsecured unsubordinated notes, which is typical of most high-yield bond offerings. The covenants for secured or subordinated notes will have important differences from those reviewed below. Issuers should carefully review and analyze with legal counsel the full contractual terms of any high-yield bonds as described in the offering memorandum and reflected in the indenture to ensure that the covenant package is tailored for its specific operational needs.

Limitation on Indebtedness

The purpose of the Limitation on Indebtedness Covenant is to:

- limit the amount of additional debt that may be incurred by the Credit Group unless cash flow is sufficient to service all debt; and
- control structural subordination by specifying where additional debt can be incurred. See *Subordination — Structural Subordination*.

An example of the covenant is provided below.

Section 4.05. Limitation on Indebtedness and Preferred Stock

(a) The Company will not, and will not permit any Restricted Subsidiary to, Incur any Indebtedness (including Acquired Indebtedness), and the Company will not permit any Restricted Subsidiary to issue Preferred Stock, provided that the Company or any Subsidiary Guarantor may Incur Indebtedness (including Acquired Indebtedness) and any Restricted Subsidiary (other than a Subsidiary Guarantor) may Incur Permitted Subsidiary Indebtedness if, after giving effect to the Incurrence of such Indebtedness and the receipt and application of the proceeds there from, (x) no Default has occurred and is continuing and (y) the Fixed Charge Coverage Ratio would be not less than 3.0 to 1.0. Notwithstanding the foregoing, the Company will not permit any Restricted Subsidiary to Incur any Disqualified Stock (other than Disqualified Stock held by the Company or a Subsidiary Guarantor, so long as it is so held).

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

[Customary and negotiated list follows here.]

The covenant includes a general prohibition on the incurrence of indebtedness unless a ratio test is satisfied (so-called "**Ratio Debt**") and exceptions to such general prohibition (such exceptions defined as "**Permitted Debt**"). Indebtedness is generally broadly defined to include guarantees, letters of credit, capital lease obligations, hedging obligations, disqualified stock of the Issuer, any preferred stock of Restricted Subsidiaries and the deferred purchase price for any assets that remain unpaid for a specified period of time. Debt that is incurred in accordance with the ratio test is commonly referred to as ratio debt.

However, Issuers may want to negotiate items that are expressly excluded as indebtedness, such as (i) debt that has been defeased, (ii) contingent letters of credit and surety bonds, (iii) debt repayable in equity and (iv) purchase price adjustments. Industry-specific and unique operational requirements for specific businesses will be included here so as to ensure that the Issuer's existing business can continue to operate even if the incurrence of ratio debt is not available. As an example, for oil and gas companies issuing high-yield bonds, additional exclusions may include (i) farm-in agreements, (ii) commodity hedges and (iii) overriding royalty agreements and other obligations payable in production.

PRACTICE TIP

In calculating the Fixed Charge Coverage Ratio, *pro forma* effect must be given to debt incurred and repaid during the calculation period. An often-overlooked exclusion to this general calculation is how to treat revolving credit borrowings and repayments. To avoid this uncertainty, such borrowings and repayments should be excluded from EBITDA for purposes of the Limitation on Indebtedness Covenant.

The Exemption for "Ratio Debt"

The most common ratio test that is used in conjunction with the Limitation on Indebtedness Covenant is the "**Fixed Charge Coverage Ratio**" (*i.e.*, the Issuer and its Restricted Subsidiaries (or often, only those Restricted Subsidiaries that are Guarantors) will only be permitted to incur additional indebtedness (other than Permitted Debt) so long as the Fixed Charge Coverage Ratio is at least equal to a predetermined ratio calculated on a *pro forma* basis after giving effect to the incurrence of the additional debt and the application of the proceeds thereof). Typically, Issuers are not eligible to incur Ratio Debt when the bonds are issued, and therefore must initially depend upon the Permitted Debt exceptions to incur additional indebtedness.

The Fixed Charge Coverage Ratio is a ratio of earnings before interest, taxes, depreciation and amortization ("**EBITDA**") of the Credit Group to fixed charges of the Credit Group. The required ratio commonly ranges

between 2.0 and 3.5 to 1.0, representing the Issuer's EBITDA to aggregate interest and similar expenses. For certain highly capitalized businesses, such as telecommunications, ratio debt will be calculated with a leverage ratio of outstanding debt to EBITDA, which is considered a better measure of gearing given the nature of the capital structure.

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

PRACTICE TIP

All or some of such adjustments described above may be made to EBITDA directly, as opposed to Net Income. The difference may be important. Net Income is used to calculate the Net Income Basket for Restricted Payments. Therefore, an Issuer will prefer to adjust Net Income, while investors will prefer to allow such adjustments only to EBITDA for purposes of the Limitation on Indebtedness Covenant. Underwriters will typically prefer that only the Issuer Guarantor are permitted to incur Ratio Debt, thereby limiting structural subordination due to non-guarantor Restricted Subsidiaries incurring unlimited Ratio Debt.

1 Alternatively, EBITDA can also be defined as Adjusted Net Income *plus* depreciation and amortization *plus* non-cash charges decreasing net income *minus* non-cash items increasing income. Adjusted Net Income is customarily defined as GAAP net income (or loss) of the Credit Group, adjusted by excluding: (i) any gain (but not loss) on any asset sale; (ii) any extraordinary gain (but not loss); (iii) net income (but not loss) of an entity that is not a Restricted Subsidiary, except to the extent distributed to the Issuer or a Restricted Subsidiary; (iv) net income of a Restricted Subsidiary to the extent restricted from being distributed to the Issuer or a Restricted Subsidiary; and (v) the cumulative effect of a change in accounting principles.

Fixed charges primarily include: (i) interest expense (cash and non-cash); (ii) amortization of debt issuance costs and original interest discount; (iii) the interest component of capital leases; (iv) dividends on preferred stock; and (v) net payments under hedging obligations. It may also include, for certain types of businesses, other charges or expenses (*e.g.*, for retail and real estate issuers, fixed charges could also include rental expenses).

The Fixed Charge Coverage Ratio is calculated based on the operating results of the Credit Group for the immediately preceding four quarters for which financial statements are available and gives *pro forma* effect to the incurrence of debt proposed to be incurred, incurrence and retirement of other debt from the beginning of the four-quarter period until the calculation date as well as acquisitions and dispositions during the same period.

Because the covenant is an "incurrence" covenant, it only tests the ratio at the time the Issuer or a Restricted Subsidiary seeks to incur additional indebtedness as Ratio Debt. An Issuer is permitted to maintain Ratio Debt even if its subsequent financial performance would prevent it from later incurring additional Ratio Debt.

Limitation on Indebtedness: Basic Illustrations

FCCR: 3.0x

Carve-out: US$500MM Credit Facility

Scenario A

(US$ 'MM)	
Credit Facility	500
Sr. Subordinated Notes	200
Total Debt	US$700
FCCR	2.5x
Additional Debt Permitted	US$0

The debt incurrence test prevents the incurrence of additional indebtedness under the ratio test and carve-outs

- Current FCCR (2.5x) is already less than FCCR (3.0x), and the credit facility carve-out has already been fully utilized

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

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

Scenario B

(US$ 'MM)		
Credit Facility	400	Although the calculation of the issuer's FCCR is below its 3.0x FCCR requirement, it has additional borrowing capacity given that it has only used up US$400MM of its US$500MM credit facility carve-out
Sr. Subordinated Notes	200	
Total Debt	US$600	
FCCR	2.5x	
Additional Debt Permitted	US$100	

PRACTICE TIP

Further, indentures often mistakenly do not provide any Permitted Debt basket for indebtedness refinanced by the Permitted Refinancing exception, which should not thereby "empty out" such Permitted Debt basket. Unless each Permitted Debt basket also includes in its calculation of the maximum amount that can be incurred there under any debt refinancing such debt, this outcome will occur and thus permit an Issuer to become more highly leveraged than the noteholders may have intended.

The Permitted Debt Exemption

The covenant will also permit numerous categories of "**Permitted Debt**" to be incurred by the Issuer and its Restricted Subsidiaries regardless of their financial performance or condition and without their having to meet the Fixed Charge Coverage Ratio Test. The specific categories of indebtedness covered by this exemption will be negotiated between the Issuer and the underwriters and are contained in the text of the Limitation on Indebtedness Covenant.

Permitted Debt typically includes:

- debt under "**the Credit Facilities Basket**," which would include the Issuer's existing credit agreement and any refinancing thereof, as well as any other indebtedness meeting the definition of "credit facility" (subject to a fixed cap but sometimes with a "grower" component);

- ordinary course debt, such as letters of credit supporting workers' compensation claims, self insurance obligations, performance, surety, appeal or similar bonds;
- debt existing on the issue date that is not otherwise included within any other Permitted Debt exception. This exception typically excludes debt outstanding on the issue date that is permitted by the Credit Facility Basket or other identified Permitted Debt exceptions so as to prevent the Issuer from "emptying-out" such other baskets by redesignating such debt as "debt existing on the issue date;"
- debt represented by the notes issued on the issue date and any related guarantees (together with any registered exchange notes and related guarantees). Because "notes" is typically defined to include all notes issued under the indenture (as a single fungible series with equal rights and identical terms), if the indenture permits follow-on notes to be issued in the future, it is typical for this exception to be limited to the initial notes so that any additional notes would have to be issued in compliance with other exemptions;
- Permitted Refinancing Debt (*i.e.*, debt incurred to refinance Ratio Debt or other certain identified categories of Permitted Debt);
- capitalized leases, mortgage financings and purchase money obligations, all subject to a cap;
- intercompany borrowings between and among the Credit Group;
- hedging obligations incurred for non-speculative purposes (and it should be noted that such allowance may differ from transactions receiving hedging treatment under applicable accounting standards);
- negotiated basket available to the Issuer and all Restricted Subsidiaries (not only Guarantors) (typically a fixed amount but sometimes with a "grower" component) for any purpose; and
- other specific carve-outs (*e.g.*, foreign subsidiary debt under local lines of credit).

PRACTICE TIP

Practitioners often question whether an initial debt incurrence may be divided between Ratio Debt and Permitted Debt, and if so, whether the portion allocated to Permitted Debt should be given *pro forma* effect in the calculation of the Fixed Charge Coverage Ratio.

Many indentures specially address this question by providing that the portion allocated to Permitted Debt, as well as the discharge of any Permitted Debt with the proceeds of such allocated amount, shall be ignored for purposes of calculating the amount of Ratio Debt that may be incurred.

Availability of Exemptions

To the extent the incurrence of a specific item of indebtedness satisfies more than one exemption or basket, the Issuer has the right under the Limitation on Indebtedness Covenant to designate the specific exemptions or baskets under which the relevant item of indebtedness is being incurred.

Generally, the Issuer may, at any time, reclassify any item of indebtedness that at such time meets the requirements of one or more exemptions (other than Indebtedness incurred under the Credit Facilities Basket). If the financial performance of the Issuer improves (resulting in increased debt incurrence capacity under the Fixed Charge Coverage Ratio exemption), the Issuer will also typically be permitted to reclassify debt initially incurred under one or more Permitted Debt baskets as Ratio Debt. This action serves to free up capacity under the relevant Permitted Debt baskets. Such a reclassification is also advantageous in the event of a refinancing of Permitted Debt. For example, refinancing debt with Ratio Debt need not comply with the limitations required by the definition of Permitted Refinancing Debt.

PRACTICE TIP

It will almost always be advantageous for the Issuer to designate, to the maximum extent possible, an incurrence of indebtedness to have been made as Ratio Debt, as opposed to pursuant to a specified Permitted Debt basket. This is because any indebtedness incurred in reliance on a basket will be factored in when calculating future proposed incurrences under the Fixed Charge Coverage Ratio anyway and also use up capacity under the specified Permitted Debt basket.

PRACTICE TIP

Typically, the Permitted Refinancing definition will restrict the amount, maturity, amortization, obligors, collateral and subordination of the refinancing indebtedness. A typical exception to such restrictions is debt under the Credit Facilities Basket, which may be refinanced without such limitations. Similarly, the definition of Permitted Refinancing Indebtedness often does not expressly prohibit a non-guarantor Restricted Subsidiary from incurring debt to refinance debt of a guarantor. The Issuer and investors should consider if they agree to permitting subordinated debt to be refinanced with senior debt and pari passu debt to be refinanced with structural subordination of the bonds.

Other Covenants to Consider

When evaluating whether the Limitation on Indebtedness Covenant provides sufficient flexibility for the Issuer, the Issuer and its advisers should also consider:

- the Limitation on Liens Covenant, if the Issuer intends to incur indebtedness that is secured by any liens;
- the Limitation on Restrictions on Dividends and Other Payments from Restricted Subsidiaries Covenant, because the incurrence of additional indebtedness may involve the imposition of contractual restrictions on dividends, asset transfers and other payments by the borrowing subsidiaries; and

- the Asset Sales Covenant, which often requires that any repayment of indebtedness with Asset Sale proceeds must be accompanied by a commitment reduction.

Limitation on Restricted Payments

The Limitation on Restricted Payments Covenant is designed to prevent cash and assets from being transferred outside the Credit Group (also referred to as "leakage") unless the Credit Group's positive financial performance or improved financial condition justifies its ability to make such payments. This protection is important to noteholders because it preserves the Issuer's ability to repay its indebtedness as well as preserving assets in the Credit Group in the event of insolvency or bankruptcy. Once transferred out, cash rarely returns to the Credit Group, and this covenant limits leakage unless such transfer rights have been earned.

As we discuss the Limitation on Restricted Payments Covenant, timing must be carefully considered. The Restricted Payments Builder Basket will be zero on the date of issuance unless "seeded" with a starter amount. It will build over time, as discussed below, if financial performance is positive. However, the Issuer will want to consider whether it expects that any Restricted Payments will be needed in the initial six to 12 months. If, for example, dividends will be declared or paid during such period, and the Issuer has a history of such payments as a public company, the working group needs to consider ways to enable the Issuer to make such payments, which will be expected by equity investors despite being "leakage" from a noteholder perspective.

The covenant is structured in three parts: (i) the definition of Restricted Payment; (ii) the calculation of the Net Income Basket (sometimes referred to as the "Restricted Payments Builder Basket") and the conditions under which a Restricted Payment may be made under the Net Income Basket; and (iii) exceptions to the Limitation on Restricted Payments (*i.e.*, instances when Restricted Payments may be made even if the conditions under the Net Income Basket are not met). An example of the covenant is provided below.

Section 4.06. Limitation on Restricted Payments. (a) The Company will not, and will not permit any Restricted Subsidiary to, directly or indirectly (the payments or any other actions described in clauses (i) through (iv) below being collectively referred to as "Restricted Payments"):

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

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

iii. *make any voluntary or optional principal payment, or voluntary or optional redemption, repurchase, defeasance, or other acquisition or retirement for value, of Indebtedness that is subordinated in right of payment to the Notes or any of the Subsidiary Guarantees; or*

iv. *make any Investment, other than a Permitted Investment;*

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

a. *a Default has occurred and is continuing or would occur as a result of such Restricted Payment;*

b. *the Company could not Incur at least US$1.00 of Indebtedness under the proviso in 4.05(a)[2]; or*

c. *such Restricted Payment, together with the aggregate amount of all Restricted Payments made by the Company and its Restricted Subsidiaries after the Measurement Date, shall exceed the sum of:*

---

2 Cross-reference relates to the Ratio Debt test under the Limitation on Indebtedness Covenant.

1. *50% of the aggregate amount of the Consolidated Net Income of the Company (or, if the Consolidated Net Income is a loss, minus 100% of the amount of such loss) accrued on a cumulative basis during the period (taken as one accounting period) beginning on the first day of the fiscal semi-annual period during which the Measurement Date occurred and ending on the last day of the Company's most recently ended fiscal quarter for which consolidated financial statements of the Company (which the Company shall use its reasonable best efforts to compile in a timely manner) are available (which may include internal consolidated financial statements); plus*

2. *100% of the aggregate Net Cash Proceeds received by the Company after the Measurement Date as a capital contribution to its common equity or from the issuance and sale of its Capital Stock (other than Disqualified Stock) to a Person who is not a Subsidiary of the Company, including any such Net Cash Proceeds received upon (x) the conversion of any Indebtedness (other than Subordinated Indebtedness) of the Company into Capital Stock (other than Disqualified Stock) of the Company, or (y) the exercise by a Person who is not a Subsidiary of the Company of any options, warrants or other rights to acquire Capital Stock of the Company (other than Disqualified Stock) in each case excluding the amount of any such Net Cash Proceeds used to redeem, repurchase, defease or otherwise acquire or retire for value any Subordinated Indebtedness or Capital Stock of the Company; plus*

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

4. *an amount equal to the net reduction in Investments (other than reductions in Permitted Investments) that were made after the Measurement Date in any Person resulting from (v) payments of interest on Indebtedness, dividends or repayments of loans or advances by such Person, in each case to the Company or any Restricted Subsidiary (except, in each case, to the extent any such payment or proceeds are included in the calculation of Consolidated Net Income) after the Measurement Date, (w) the unconditional release of a Guarantee provided by the Company or a Restricted Subsidiary after the Measurement Date of an obligation of another Person, (x) to the extent that an Investment made after the Measurement Date was, after such date, or is sold or otherwise liquidated or repaid for cash, the lesser of (i) cash return of capital with respect to such Investment (less the cost of disposition, if any) and (ii) the initial amount of such Investment, (y) from redesignations of Unrestricted Subsidiaries as Restricted Subsidiaries, not to exceed, in each case, the amount of Investments (other than Permitted Investments) made by the Company or a Restricted Subsidiary after the Measurement Date in any such Person, or (z) any Person becoming a Restricted Subsidiary (whereupon all Investments made by the Company or any Restricted Subsidiary in such Person since the Measurement Date shall be deemed to have been made pursuant to clause (1) of the definition of "Permitted Investment") but only to the extent such Investments by the Company or any Restricted Subsidiary in such Person was a Restricted Payment made to the extent permitted under this paragraph (c); plus*
5. *US$20.0 million (or the Dollar Equivalent thereof).*

d. *The foregoing provision shall not be violated by reason of:*

[Customary list of exclusions follow here.]

Definition of Restricted Payments

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

- paying cash dividends or making other distributions of assets to stockholders; *provided, however*, that dividends paid in stock (other than disqualifying stock) and dividends paid by a Restricted Subsidiary to the Issuer or another Restricted Subsidiary are excluded (*i.e.*, are not Restricted Payments or are otherwise permitted exceptions);
- repurchasing capital stock of the Issuer;
- repaying subordinated debt prior to scheduled maturity; and
- making Investments outside the Credit Group (other than Permitted Investments, which are discussed below).

The term "Investment" is defined very broadly and consists generally of:

- purchases of equity or debt securities of another entity;
- capital contributions to any entity; and
- loans to, or guarantees or other credit support for, the benefit of any entity.

Investments are generally treated as Restricted Payments because they typically involve assets of the Issuer or its Restricted Subsidiaries being transferred to a third party outside the Credit Group. Because investments may be both Permitted Investments and Restricted Payments, it is important to remember the Issuer is permitted to aggregate multiple baskets to make an Investment.

The covenant does not restrict acquisitions of companies that become Restricted Subsidiaries, capital expenditures, and most intra-group loans and guarantees as all of these transactions represent investments "in the system" within the Credit Group.

Calculation of the Net Income Basket

The Net Income Basket is calculated as follows:

- 50% cumulative Adjusted Net Income (minus 100% of any loss), for the period from the beginning of the quarter (or six-month period if the Issuer does not prepare audited or reviewed quarterly financial statements) immediately prior to or after the date the bonds are originally issued until the end of the most recent quarter for which financial statements are available; *plus*

- cash proceeds (and often the fair market value of any assets) from (i) capital contributions to the Issuer, (ii) issuances of equity by the Issuer (other than (x) disqualified stock and (y) issuances to a subsidiary) and (iii) issuances since the issue date of the bonds of *pari passu* or senior debt of the Issuer and its Restricted Subsidiaries subsequently converted or exchanged equity (other than by a subsidiary of the Issuer) into Issuer (other than disqualified stock); *plus*
- a negotiated dollar amount (in some cases); *plus*
- net reductions in Investments that have been made under the Net Income Basket (to the extent not included in Adjusted Net Income) such as:
  - » the aggregate net proceeds (including the fair market value of assets other than cash) received by Issuer or any Restricted Subsidiary upon the sale or other disposition of any Investment made pursuant to the Net Income Basket;
  - » the net reduction in Investments made pursuant to the Net Income Basket resulting from dividends, repayments of loans or advances or other transfers of assets to Issuer or any Restricted Subsidiary;
  - » to the extent that the amount available for Investments under the Net Income Basket was reduced as the result of the designation of an Unrestricted Subsidiary, the portion (proportionate to Issuer's equity interest in such Subsidiary) of the fair market value of the net assets of such Unrestricted Subsidiary at the time such Unrestricted Subsidiary is redesignated, or liquidated or merged into, a Restricted Subsidiary; and
  - » the net reduction in Investments made pursuant to the Net Income Basket resulting from repayment of letters of credit, the expiration of a letter of credit undrawn or the release of any guarantees.

Restricted Payments Calculation: An Example

(US$ 'MM)	Period 1	Period 2	Period 3
Net Income..............	100	100	100

50% of Net Income for the relevant periods = US$300,000,000 x 50% = **US$150,000,000**, which would be reduced by any Restricted Payments made during such periods

Restricted Payments: Basic Illustrations

Basic Calculation: 50% Net Income
Carve-out: US$100MM General
FCCR: 3.0x

Scenario A

(US$ 'MM)		
FCCR	3.5x	The issuer is able to utilize its entire US$150MM basket calculation as its FCCR of 3.5x exceeds the 3.0x FCCR requirement as well as the US$100MM general carve-out, which has not yet been used
General Carve-out Used	US$0	
Rest. Pmt. Basket Calculation	US$150	
Permitted Restricted Payment	**US$250**	

Scenario B

(US$ 'MM)		
FCCR	2.5x	Although the issuer has a basket calculation of US$150MM, the issuer is not able to incur US$1.00 of additional indebtedness because the issuer has an FCCR of 2.5x and it must have an FCCR of at least 3.0x
General Carve-out Used	US$0	
Rest. Pmt. Basket Calculation	US$150	
Permitted Restricted Payment	**US$100**	However, the issuer is still able to utilize the US$100MM general carve-out which has not been used

Scenario C

(US$ 'MM)		
FCCR	2.5x	The restricted payments test prevents the issuer from making a restricted payment even though the basket calculation is US$150MM
General Carve-out Used	US$100	
Rest. Pmt. Basket Calculation	US$150	The limiting factor is that the issuer is not able to incur US$1.00 of additional indebtedness under its 3.0x FCCR requirement as its current FCCR is 2.5x
Permitted Restricted Payment	**US$0**	Also, the issuer's general carve-out has already been utilized

Conditions to Using the Net Income Basket

Restricted Payments cannot be made utilizing the Net Income Basket unless:

- the amount of the proposed Restricted Payment *plus* all prior Restricted Payments since the original issue date of the bonds (subject to certain exceptions discussed below) does not exceed the amount of the Net Income basket;
- the Issuer can incur US$1.00 of Ratio Debt under the Limitation on Indebtedness Covenant (after giving *pro forma* effect to the Restricted Payment); and
- no default exists or would exist under the indenture after giving effect to the Restricted Payment (*i.e.*, the Issuer must give *pro forma* effect of the Restricted Payments when calculating the Restricted Payments covenant compliance).

PRACTICE TIP

To avoid double counting, investors will want to make sure that if capital contributions or equity proceeds are a separate basis for making a Permitted Investment or Permitted Restricted Payment, any capital contribution or equity proceeds used for those specific exceptions is not also used to increase the amount of the Net Income Basket.

Permitted Restricted Payments

Certain Restricted Payments can be made without regard to the Net Income Basket or the conditions to using the Net Income Basket ("**Permitted Restricted Payments**") and they include:

- the acquisition of equity out of the proceeds of, or in exchange for, a concurrent issuance of new equity;
- repurchases of subordinated debt out of proceeds of concurrent issuance of new equity or new subordinated Permitted Refinancing Debt;
- a general basket for any Restricted Payment, subject to an aggregate dollar cap;
- pro-rata dividends of Restricted Subsidiaries paid to third parties; and

- other negotiated exceptions (*e.g.*, limited investments, limited repurchase of management stock or specific exceptions necessitated by the Issuer's capital structure).

As a general matter, all Permitted Restricted Payments count against the Net Income Basket other than Restricted Payments that either:

- expressly provide that the assets or cash utilized in such Permitted Restricted Payment do not also build the Net Income Basket (*e.g.*, those made with the proceeds of, or in exchange for, an equity issuance);
- are credit-neutral (*e.g.*, the permitted refinancing of subordinated debt); or
- are *de minimis* (loan to officers, etc.).

Permitted Investments

Permitted Investments are, by definition, not Restricted Payments.

When determining permitted investments, practical consideration must be given to how the Issuer conducts its business and whether it has a history of making the permitted investments being proposed. Although some bond structures seem to adopt a "lowest common denominator" approach where all possible carve-outs are proposed, a better approach is to tailor the package to fit the Issuer's current and future needs precisely.

Permitted Investments generally include:

- investments in the Issuer, any Restricted Subsidiary (sometimes limited to Investments in Guarantors and not encompassing non-Guarantor subsidiaries of the Issuer, even if classified as Restricted Subsidiaries) or any entity that becomes a Restricted Subsidiary as a result of the Investment;
- certain enumerated hedging transactions;
- loans or advances to officers or directors, subject to a cap;
- investments in joint ventures, subject to a cap; and
- other investments, subject to a cap.

PRACTICE TIP

Permitted Investments are specially excluded from the definition of Restricted Payments. As such, because they are not Restricted Payments, they do not count against the Net Income Basket. Consequently, an Issuer will prefer that an Investment be permitted as a Permitted Investment rather than as a Permitted Restricted Payment so as to preserve the basket for other uses.

An Issuer will want to provide that any Investments made pursuant to a general exception over time that results in such entity becoming a subsidiary will automatically be made under the "Investments in Subsidiaries" exception, thus "emptying out" the general exception.

An Issuer will want to provide that any Restricted Payment or Permitted Investment basket subject to a cap should be netted against any distributions and returns on Investments made pursuant to such baskets.

Availability of Exceptions

In the event that a Restricted Payment or Permitted Investment meets the criteria for incurrence under the Net Income Basket and more than one of the types of Permitted Restricted Payments or Permitted Investments, most indentures will generally permit the Issuer to classify and, from time to time, to reclassify any such item in its sole discretion. In particular, if the financial performance of the Issuer improves, which would result in availability under the Net Income Basket, the Issuer will typically (but not always) be permitted to reclassify any item initially incurred under one or more Restricted Payment Baskets or Permitted Investments baskets as a Restricted Payment under the Net Income Basket, thereby freeing up capacity under the relevant baskets.

Other Covenants to Consider

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

Limitation on Dividends and Other Payments from Restricted Subsidiaries

This covenant (often called the "**Limitation on Dividend Stoppers Covenant**") prevents cash flow needed to service debt of the Issuer from being trapped at a subsidiary level (*i.e.*, noteholders want all cash generated by Restricted Subsidiaries to be able to freely flow up to the Issuer so that it may be used to satisfy obligations under the bonds). As such, the covenant is a general prohibition on the existence of any restriction on Restricted Subsidiaries (alternately, sometimes limited to non-Guarantors) to pay dividends, repay indebtedness, make loans or otherwise transfer assets to the Issuer or any other Restricted Subsidiary. This covenant is important to investors because they look to the credit quality and financial condition of the Issuer and its Restricted Subsidiaries as a whole for the repayment of the bonds, not just the Issuer.

Common exceptions to the covenant include:

- restrictions existing in existing indebtedness (and sometimes any other indebtedness that is permitted to be incurred);
- restrictions already in place when a subsidiary is acquired (provided such restrictions are not incurred in anticipation of such acquisition);
- applicable law;
- customary lease provisions; and
- restrictions in refinancings of existing debt, if the limitations are not more restrictive than those being refinanced.

Joint ventures entered into by the Issuer or its Restricted Subsidiaries may present obstacles in the context of this covenant because the partner in such joint venture will typically have veto rights over dividend payments. One possible solution is the formation of a joint venture that is less than 50% Issuer-owned; such a joint venture would not be a "Subsidiary" and thus would not be a Restricted Subsidiary, subject to the indenture covenants. However, any investment in the joint venture would then count as a Restricted Payment that would be subject to the requirements of the Limitation on Restricted Payments covenant. Regardless, careful attention

should be paid to the Issuer's past and expected use of joint venture arrangements to conduct its business. A relevant and common example in Asia is the use of joint venture vehicles by real estate developers to hold specific projects.

Other Covenants to Consider

The Limitation on Dividend Stopper Covenant should be reviewed in conjunction with the Limitation on Indebtedness Covenant since indebtedness that otherwise may be incurred may be limited by this covenant if the terms of the additional indebtedness contain any provisions that restrict the movement of cash or assets around the Credit Group.

Limitation on Liens

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

An example of the covenant is provided below.

Section 4.07. Limitation on Liens.

a. *The Company will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly, incur, assume or permit to exist any Lien on the Collateral (other than Permitted Liens).*

b. *The Company will not, and will not permit any of its Restricted Subsidiaries to, directly or indirectly incur, assume or permit to exist any Lien of any nature whatsoever on any of its assets or properties of any kind (other than the Collateral), whether owned at the Original Issue Date or thereafter acquired, except Permitted Liens, unless the Notes are equally and ratably secured by such Lien.*

Similar to other high-yield covenants, however, the exceptions contained in the definition of Permitted Liens must be carefully reviewed. Permitted Liens typically include:

- liens securing debt permitted under the Credit Facilities Basket;
- purchase money liens;
- liens on acquired property that were not incurred in contemplation of the acquisition;
- liens securing secured Permitted Refinancing Debt, *provided* that the liens are only on the same assets that secured the debt being refinanced; and
- liens existing on the issue date that are not otherwise included within any other Permitted Lien exception.

For Asia-based issuers, the Permitted Liens definition can stretch beyond customary items for all issuers to include country-specific items driven by local bank lending customs and industry-specific lien requirements tied to the Issuer's operating environment.

Other Covenants to Consider

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

Limitation on Sales of Assets and Subsidiary Stock

Because sales of assets and subsidiary stock may result in income-producing assets being transferred outside the Credit Group, the covenant package limits external leakage possibly deteriorating the Issuer's financial position by ensuring that certain procedural requirements are met in connection with sales of assets and subsidiary stock. As such, the restrictions of the covenant do not limit the amount of assets the Credit Group is permitted to sell; rather, the covenant governs the type of proceeds that may be received as consideration and defines appropriate uses for the proceeds from such sales. Under the covenant, a minimum

percentage (typically between 75% and 85%) of the consideration from the sale must be cash or "deemed cash." To add flexibility, issuers often request that this percentage is based on the aggregate consideration received on all asset sales since the date of the indenture.

PRACTICE TIP

As used in the asset sale covenant in an unsecured unsubordinated indenture, "Senior Debt" should be defined as debt structurally senior to the bonds (*e.g.*, first-lien obligations or debt of non-Guarantor Restricted Subsidiaries (other than intercompany debt)). Debt that ranks *pari passu* with the bonds should only be permitted to be repaid under this covenant on a *pro rata* basis with the bonds. Likewise, the definition of "net cash proceeds" should not deduct the repayment of any debt other than "Senior Debt."

While the definition of "deemed cash" is negotiated, it often includes (i) unsubordinated debt assumed by the buyer, so long as the Credit Group is unconditionally released and (ii) cash equivalents that are converted into cash within a specified period of time (generally 90 to 180 days). Some indentures also permit "replacement assets" or long-term assets that are used or useful in the Issuer's business and equity in an entity that will become a Restricted Subsidiary as a type of "deemed cash."

PRACTICE TIP

To avoid uncertainty regarding the need to segregate asset sale proceeds, the Issuers will want to ensure that the covenant directs the use of "cash equal in amount to the net available cash proceeds," as opposed to the actual cash proceeds. Cash is fungible and as long as the Issuer or the relevant Restricted Subsidiary makes capital expenditures within the relevant time frame following an asset sale, compliance with the covenant should normally not be difficult.

The definition of "asset sales" is typically broadly defined and will generally include traditional asset disposals and any direct and indirect sales of interests in Restricted Subsidiaries, including any issue of new shares of a Restricted Subsidiary or any disposition by means of a merger, consolidation or similar transaction. Moreover, the definition will include categories of asset disposals that do not need to satisfy the asset sale test, including ordinary course transactions and a carve-out for transactions below a specified minimum fair market value.

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

As a covenant primarily focusing on ensuring proper safeguards on asset sales (and not forbidding such sales themselves), the asset sale test requires:

- the Issuer or the relevant Restricted Subsidiary to receive consideration equal to the fair market value of the assets sold;
- at least a minimum percentage (typically between 75% and 85%) of the consideration from the sale to be in the form of cash or "deemed cash;" and
- the Issuer or the relevant Restricted Subsidiary to apply the net cash proceeds from the asset sale within a specified period of time (usually 365 days) to acquire non-current assets or stock of another entity in the same business line that becomes a Restricted Subsidiary, to make capital expenditures and/or to repay "Senior Debt" (sometimes also requiring a permanent commitment reduction).

To the extent the net cash proceeds from an asset sale are not applied in accordance with the specified uses within the specified period of time, such unused net cash proceeds become "excess proceeds." When the aggregate amount of excess proceeds from all asset sales exceeds a specified dollar amount, the Issuer must use those excess proceeds to offer to repurchase, on a pro rata basis, the bonds at their face value, plus accrued interest and other *pari passu* debt with similar repayment requirements.

An example of the covenant is provided below.

Section 4.13. Limitation on Asset Sales.

a. *The Company will not, and will not permit any Restricted Subsidiary to, consummate any Asset Sale, unless:*

   i. *no Default shall have occurred and be continuing or would occur as a result of such Asset Sale;*

   ii. *the consideration received by the Company or such Restricted Subsidiary, as the case may be, is at least equal to the Fair Market Value of the assets sold or disposed of;*

   iii. *in the case of an Asset Sale that constitutes an Asset Disposition, the Company could Incur at least US$1.00 of Indebtedness under the proviso in Section 4.05 (a)*[3] *after giving pro forma effect to such Asset Disposition; and*

   iv. *at least 75% of the consideration received consists of cash, Temporary Cash Investments or Replacement Assets; provided that in the case of an Asset Sale in which the Company or such Restricted Subsidiary receives Replacement Assets involving aggregate consideration in excess of US$10.0 million (or the Dollar Equivalent thereof), the Company shall deliver to the Trustee an opinion as to the fairness to the Company or such Restricted Subsidiary of such Asset Sale from a financial point of view issued by an accounting, appraisal or investment banking firm of international standing. For purposes of this provision, each of the following will be deemed to be cash:*

      1. *any liabilities, as shown on the Company's most recent consolidated balance sheet, of the Company or any Restricted Subsidiary (other than contingent liabilities and liabilities that are by their terms subordinated to the Notes or any Subsidiary Guarantee) that are assumed by the transferee of any such assets pursuant to a customary assumption, assignment, novation or similar agreement that releases the Company or such Restricted Subsidiary from further liability; and*

3 Cross-reference relates to the Ratio Debt test under the Limitation on Indebtedness Covenant.

2. *any securities, notes or other obligations received by the Company or any Restricted Subsidiary from such transferee that are promptly, but in any event within 30 days of closing, converted by the Company or such Restricted Subsidiary into cash, to the extent of the cash received in that conversion.*

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

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

   ii *acquire properties and assets that replace the properties and assets that were the subject of such Asset Sale or Replacement Assets.*

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

   i. *accumulated Excess Proceeds, multiplied by*

   ii. *a fraction: 1. the numerator of which is equal to the outstanding principal amount of the Notes and 2. the denominator of which is equal to the outstanding principal amount of the Notes and all pari passu Indebtedness similarly required to be repaid, redeemed or tendered for in connection with the related Asset Sale,*

   iii. *rounded down to the nearest US$1,000.*

d. *The offer price in any Offer to Purchase will be equal to 100% of the principal amount of the Notes plus accrued and unpaid interest to the date of purchase, and will be payable in cash.*

e. *If any Excess Proceeds remain after consummation of an Offer to Purchase, the Company may use those Excess Proceeds for any purpose not otherwise prohibited by this Indenture. If the aggregate principal amount of Notes (and any other pari passu Indebtedness) tendered in such Offer to Purchase exceeds the amount of Excess Proceeds, the Trustee will select the Notes (and such other pari passu Indebtedness) to be purchased in accordance with the procedures set out under Section 3.02. Upon completion of each Offer to Purchase, the amount of Excess Proceeds will be reset at zero*

Limitation on Affiliate Transactions

The purpose of the Limitation on Affiliate Transactions Covenant is to avoid leakage from the Credit Group to controlling stockholders and other affiliates through transactions priced or structured on an abnormally favorable basis, thereby potentially stripping value from the Credit Group. An affiliate is typically defined to include any person who controls, or is under common control with, the Issuer and usually includes any shareholder above a specified percentage (usually between 5% and 10%).

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

- the transaction is conducted on an arm's-length basis;
- if the transaction value exceeds a negotiated threshold amount (usually US$1 million to US$5 million, depending on the Issuer's size at the time the bonds are issued), the transaction is approved by a majority of the Issuer's board of directors, including a majority of disinterested directors (although sometimes this approval is required only from an officer); and

- if the transaction value exceeds a higher threshold amount, the Issuer obtains a fairness opinion from an independent investment bank, accounting or appraisal firm (although often this approval is required only from the Issuer's board of directors).

Typical exemptions to the covenant include (i) transactions between and among the Issuer and its Restricted Subsidiaries, (ii) payment of reasonable and customary fees to directors, (iii) Restricted Payments made in accordance with the Limitation on Restricted Payments Covenant and Permitted Investments and (iv) payment of management fees to leveraged buyout sponsors.

Limitation on Designation of Restricted and Unrestricted Subsidiaries

The Limitation on Designation of Restricted Subsidiaries and Unrestricted Subsidiaries ensures that the various other covenants are not thwarted through the designation and re-designation of Restricted Subsidiaries and Unrestricted Subsidiaries.

As a general rule, all subsidiaries of the Issuer are Restricted Subsidiaries unless a subsidiary is listed as an Unrestricted Subsidiary in the indenture or the Issuer subsequently expressly designates a Restricted Subsidiary as an Unrestricted Subsidiary in accordance with the requirements of the indenture. The Issuer may designate and redesignate its subsidiaries as either Restricted Subsidiaries or Unrestricted Subsidiaries at any time as provided by the covenant. However, because the covenants will not apply to Unrestricted Subsidiaries, noteholders may view the Issuer's designations and re-designations as a way to potentially circumvent the otherwise applicable restrictions on investments, incurring indebtedness or engaging in acquisitions and dispositions.

By designating a subsidiary as unrestricted, the Issuer is deemed to have made an investment in the subsidiary in an amount equal to the fair market value of the Issuer's or its Restricted Subsidiary's interest in the subsidiary at the time of the designation, *provided* that in order to

designate a Restricted Subsidiary as an Unrestricted Subsidiary, the following conditions must be met:

- the Issuer must comply with the Limitation on Restricted Payments Covenant (*i.e.*, the fair market value of the Issuer's deemed Investment in the relevant subsidiary at the time of designation must be permitted under the Restricted Payments covenant or as a Permitted Investment. Such Investment will be valued at the fair market value of the sum of the net assets of such subsidiary at the time of designation and the amount of any indebtedness of such subsidiary owed to the Issuer and any Restricted Subsidiary);
- the Issuer must comply with the Limitation on Indebtedness Covenant (*i.e.*, any guarantee by the Issuer or the remaining Restricted Subsidiaries of any indebtedness of the Unrestricted Subsidiary will be deemed to be an incurrence of additional indebtedness). Typically, the Unrestricted Subsidiary may only incur "nonrecourse debt," which prohibits the Unrestricted Subsidiary from incurring any debt that is guaranteed or secured by the Issuer or any Restricted Subsidiary. In addition, the Issuer and its Restricted Subsidiaries are often prohibited from being the lenders of any debt to an Unrestricted Subsidiary;
- the newly designated Unrestricted Subsidiary must not hold capital stock or indebtedness of, or hold any liens on the assets of, or have any investment in, the Issuer and its remaining Restricted Subsidiaries;
- the Issuer must comply with the Limitation on Affiliate Transactions Covenant (*i.e.*, any agreement, transaction or arrangement between the Issuer, the newly Unrestricted Subsidiary and the Issuer's remaining Restricted Subsidiaries must comply with the Limitation on Affiliate Transactions Covenant);
- the Issuer and its remaining Restricted Subsidiaries must not have any obligation to (i) subscribe for additional equity in the newly designated Unrestricted Subsidiary or (ii) maintain or preserve the financial condition of the newly designated Unrestricted Subsidiary (whether by guarantee or extension of credit); and
- the designation will not result in a default or an event of default.

In order to designate an Unrestricted Subsidiary as a Restricted Subsidiary, the following conditions must be met:

- the designation must be made in compliance with the Restricted Payments Covenant (*i.e.*, any investment held by the newly designated Restricted Subsidiary must be able to be made in accordance with the Limitation on Restricted Payments Covenant or as a Permitted Investment);

- any debt of the newly designated Restricted Subsidiary must be able to be made in accordance with the Limitation on Indebtedness Covenant;
- any liens on the newly designated Restricted Subsidiary's assets must be in compliance with the Limitation on Liens Covenant; and
- the designation will not result in default or an event of default.

Limitation on Merger, Consolidation and Sale of Substantially All Assets

The goal of the covenant in limiting mergers, consolidations and sales of substantially all assets (the "**Mergers Covenant**") is to prevent a business combination in which the resulting entity is not financially healthy, as measured by the Fixed Charge Coverage Ratio. The covenant prohibits the Issuer from merging with or consolidating into another entity, or transferring all or substantially all of the Credit Group's assets to another entity, unless the following general conditions are satisfied:

- either the Issuer is the surviving entity or the surviving entity is an entity organized under the laws of a specified jurisdiction (*e.g.*, the jurisdiction under which the Issuer is organized) and expressly assumes the Issuer's obligations under the bonds and the indenture;
- the Issuer or the surviving entity must be able to incur at least US$1.00 of Ratio Debt under the Limitation on Indebtedness Covenant on a *pro forma* basis (although sometimes this condition requires only that the Issuer's Fixed Charge Coverage Ratio is no worse as a consequence of the transaction even if it still could not incur US$1.00 of Ratio Debt); and
- the absence of default, either before or as a result of the transaction.

PRACTICE TIP

High-yield bonds for Asia-based issuers typically also require the Issuer or surviving entity to have a consolidated net worth equal to or greater than the consolidated net worth of the Issuer prior to the transaction.

As the covenant restricts certain transactions that may also constitute a change of control giving noteholders the option to put their bonds back to the Issuer, this covenant should be negotiated in conjunction with the Change of Control Covenant. If the bonds are guaranteed by the Issuer's subsidiaries, then the Mergers Covenant will also prohibit any Subsidiary Guarantor from merging with or consolidating into another entity, or transferring all or substantially all of the Subsidiary Guarantor's assets to another entity, unless the following general conditions are satisfied:

Either:

a. (i) the transaction will result in the Subsidiary Guarantor no longer being a subsidiary of the Issuer, (ii) the transaction complies with the Limitation of Asset Sales Covenant and (iii) the Subsidiary Guarantor is released from its guarantee of the bonds in accordance with the terms of the indenture; or
b. (i) either the Subsidiary Guarantor is the surviving entity or the surviving entity is an entity organized under the laws of a specified jurisdiction and expressly assumes the Subsidiary Guarantor's obligations under its bonds guarantee and (ii) the absence of any default under the indenture, either before or as a result of the transaction.

Change of Control

The Change of Control Covenant protects noteholders from fundamental changes in the Issuer's ownership structure and/or board composition. Investors have traditionally insisted on a change of control put option because the identity, track record and financial and business strategies of the Issuer's ultimate owners can be a significant factor in investors' initial investment decision. This can be particularly true for portfolio companies of private equity sponsors that are repeat players in the high-yield markets. If significant changes in ownership occur during the life of the bonds, investors want the chance to exit the credit.

Upon the occurrence of any of a series of specified change of control events, the Issuer is required to make an offer (*i.e.*, a change of control offer) to repurchase the bonds at a specific percentage (usually 101%) of their principal amount. Specific change of control events can be heavily negotiated between the Issuer and the underwriters (especially where an

initial public offering or partial sale of the Issuer within the terms of the bonds are realistic scenarios), but will ordinarily include:

- the acquisition by a person or group of people (other than defined permitted equity holders) of more than a specific percentage (generally between 30% and 50%) of the Issuer's voting capital;
- a contested change in the Issuer's board of directors (*e.g.*, from a proxy fight); and
- dispositions of all or substantially all of the Credit Group's assets.

PRACTICE TIP

"Permitted Holders" may be expanded to include classes or categories of likely potential acquirers if likely during the life of the bonds and especially where investors might welcome such ownership participation. Examples include quasi-sovereign or sovereign wealth funds or development organizations in frontier market situations.

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

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

Reporting Requirements

The purpose of the reporting covenant is to ensure the continuous availability of current information regarding the Issuer's financial performance. While it may appear to be a boilerplate covenant, potential investors can be very sensitive about the content of this covenant and generally require the Issuer to provide full public disclosure for as long as the bonds are outstanding, whether or not the Issuer is subject to the United States Securities and Exchange Commission (the "**SEC**") or other reporting requirements. Public

availability of current information regarding the Issuer's financial performance is important not only for the development of a liquid market in the bonds, but it also protects noteholders that may wish to sell their bonds from potential liability for market abuse. Additionally, the availability of current information on the Issuer's financial performance is necessary to permit U.S. investors to resell their bonds within the United States in reliance on Rule 144A. See *Legal Considerations — Transaction structure and U.S. Federal Securities Law — Rule 144A*.

In Asia, given the various existing public disclosure requirements with which Issuers may be complying, the requirements need to be carefully tailored. Typically, the baseline information required is semi-annual audited financial statements plus certain annual report information. Issuers need to evaluate the requirements to ensure that any expansions of the information requirements from what is prepared in the ordinary course are carefully considered. The requirement for financial statement delivery should be aligned with the Net Income Basket calculation. See *Limitation on Restricted Payments — Calculation of the Net Income Basket*.

Limitation on Business Activities

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

Limitation on Issuances of Guarantees of Indebtedness

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

Use of Proceeds

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

Payments for Consent

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

Global Comparison of High-Yield Bond Covenant Packages

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

		Guarantors
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Bonds are often guaranteed by all Restricted Subsidiaries, other than foreign subsidiaries (due largely to tax reasons) and immaterial subsidiaries. Often only Restricted Subsidiaries that guarantee other debt of the issuer and/or incur debt are required to become guarantors.
	EUROPE	As a starting position, comprehensive guarantor coverage (at least 80%+/ as close as possible to 100% of EBITDA, revenue and assets) for "senior bonds" is common and desirable. Guarantor coverage would ideally include all (material) domestic and foreign subsidiaries. In practice, however, the corporate and insolvency laws of many European jurisdictions significantly limit the usefulness and enforceability of upstream guarantees, unless there is a clear and direct corporate benefit to the relevant subsidiary guarantor.
	ASIA	Asian high-yield bonds issued by issuers outside the PRC follow the U.S. or European guarantor models. For high-yield bonds issued by PRC-based issuers, noteholders outside of the PRC only receive subsidiary guarantees from non-PRC subsidiaries, which typically account for only a nominal proportion of the issuer's assets. As such, the issue of structural subordination becomes a dominant characteristic of high-yield bond structures involving issuers with substantial assets or operations in the PRC.

Limitation on Indebtedness		
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Fixed charge coverage ratio is typically 2.0, but can range from 2.0 to 2.5. Typically, non-guarantor Restricted Subsidiaries are not permitted to incur ratio debt, thereby reducing structural subordination. Trend is to define credit facility exception to include debt securities offerings as well as commercial bank credit facilities. Trend is for other dollar baskets such as purchase money debt or the general debt basket to be capped at the greater of a fixed dollar amount or a growth component (*e.g.*, percentage of Consolidated Net Total Assets). Issuers prefer to include ability to later reclassify debt incurred under a basket as ratio debt if fixed charge coverage ratio could be met, thereby allowing the basket to be "refreshed."
	EUROPE	Fixed charge coverage ratio is typically 2.0, but can range from 2.0 to 2.5. Typically, non-guarantor Restricted Subsidiaries are not permitted to incur ratio debt, thereby reducing structural subordination. Common to include additional "consolidated secured debt ratio" test (consolidated total debt/consolidated EBITDA) for incurrence of additional ratio debt that is secured by liens to get rating agencies and investors comfortable that Issuer will not increase its gearing excessively. Especially for cyclical businesses with currently high EBITDA, consolidated secured debt ratio (rather than fixed charge coverage ratio) can become principal limitation on ability to incur additional ratio debt. Credit facility exception typically includes debt securities offerings as well as commercial bank credit facilities. Issuers prefer to include ability to later reclassify debt incurred under a basket as ratio debt if ratio test could be met, allowing the relevant baskets to be "refreshed."
	ASIA	Fixed charge coverage ratio is between 2.0 and 3.5.[4]

4 Under high-yield bonds issued by PRC-based issuers, the fixed charge coverage ratio typically is between 2.5 and 3.5. Under high-yield bonds issued by Indonesia-based issuers, the fixed charge coverage ratio typically is between 2.0 and 3.5.

Limitation on Indebtedness

	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	ASIA (CON'T)	For high-yield bonds issued by PRC-based issuers, non-guarantor Restricted Subsidiaries are not allowed to incur debt under the fixed charge coverage ratio. It is also common, under high-yield bonds issued by PRC-based issuers, to limit the incurrence of debt by Restricted Subsidiaries to 10% to 15% of total assets, although this may exclude any debt issued in a public or private offering to institutional investors. Most high-yield bond offerings by PRC-based issuers do not have a credit facility carve-out. With respect to permitted debt, high-yield bonds issued by PRC-based issuers limit the general debt basket (and other baskets) to a fixed dollar amount or percentage of total assets, although weaker bonds typically use the greater of a fixed dollar amount and a percentage of total assets, which can include certain intangible assets. High-yield bonds issued by Indonesia-based issuers sometimes include the concept of permitted priority indebtedness, in which structurally subordinated debt can be incurred by non-guarantors if (i) structurally and contractually subordinated debt is less than 15% of total assets and (ii) the applicable ratio test is satisfied.

Limitation on Restricted Payments

	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Typical negotiated items: • In the context of calculating the build-up of the general restricted payments basket, whether equity contributions and offering proceeds can be the fair market value of non-cash consideration, or only cash. • Whether equity that is issued to make an "equity claw" redemption of the notes during the no-call period can also be counted toward the build-up of the general restricted payments basket. • Whether the "return on investments" component of the general restricted payments basket is calculated on each separate investment (whereby the basket cannot increase by more than the amount of the individual investment) or whether it is calculated on an aggregate basis among all investments (which is more issuer friendly).

		Limitation on Restricted Payments
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES (CON'T)	• Whether an issuer can later reclassify a restricted payment made under a specific basket (due to the inability to meet the fixed charge coverage ratio condition at the time of the investment) as a restricted payment made under the general basket (once the issuer is able to meet the fixed charge coverage ratio condition). • Buyback of management stock subject to an annual cap with a roll-over for unused amounts. • Dividends on disqualified stock incurred under the debt covenant as long as the dividend are included as fixed charges. • Unlike some European sponsor deals, U.S. deals typically do not permit unlimited restricted payments subject only to leverage test.
	EUROPE	Typical negotiated items: • In the context of calculating the build-up of the general restricted payments basket, whether equity contributions and offering proceeds can be the fair market value of non-cash consideration, or only cash. • Whether equity that is issued to make an "equity claw" redemption of the notes during the no-call period can also be counted toward the build-up of the general restricted payments basket. • Size of general restricted payment basket, joint venture permitted investment basket and general permitted investment basket.
	ASIA	High-yield notes issued by PRC-based issuers often include the restricted payment basket as a component of the build-up basket rather than as a separate carve-out, which forces the issuer to comply with the fixed charge coverage ratio test in order to use the general restricted payment basket. In high-yield notes issued by Indonesia-based issuers, intercompany subordinated debt may be permitted to be prepaid and there may be up to a US$10 million general basket for restricted payments.

		Limitation on Liens
	NOTEHOLDER PROTECTION LEVEL	Strongest similar protection in the United States and Europe and weaker protection in Asia
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Attention should be given to whether all permitted debt under "credit facilities" may be secured by a permitted lien (including ratio debt) or only debt under the specific credit facility basket. Covenant generally triggered by liens securing debt, as opposed to the incurrence of liens for other purposes.
	EUROPE	Attention should be given to whether all permitted ratio debt and "credit facilities" debt may be secured by a permitted lien or, if a secured deal, permitted collateral lien, or only debt under the specific credit facility basket. Covenant generally triggered by liens securing debt, as opposed to the incurrence of liens for other purposes.
	ASIA	Debt permitted under the debt covenant is typically permitted to be secured. Many high-yield notes issued by PRC-based issuers do not have a credit facility debt basket and thus no corresponding lien basket. Secured notes issued by PRC-based issuers often allow permitted pari passu debt with no ratio test, which effectively allows for unlimited dilution of the collateral.

		Limitation on Sales of Assets and Subsidiary Stock
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Covenant has become progressively weaker in the current market. Negotiated items typically include: • Types of consideration that will constitute "deemed cash" toward the 75% cash consideration requirement. Recently, some deals permit the designation of certain proceeds up to a cap as "deemed cash." • Type of debt that can be repaid with asset sale proceeds as a permitted use of proceeds (debt structurally senior to the notes or any non-subordinated debt). • Transactions that are excluded from the definition of "Asset Sale." • Asset sale proceeds generally don't have to be spent within 365 days (or other specified time period) as long as a binding contract is in place within such time period, and the proceeds are in fact spent during a subsequent 180-day period.

		Limitation on Sales of Assets and Subsidiary Stock
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	EUROPE	Negotiated items typically include: • Types of consideration that will constitute "deemed cash" toward the 75% cash consideration requirement. • Type of debt that can be repaid with asset sale proceeds as a permitted use of proceeds (debt structurally senior to the notes or any non-subordinated debt). • Transactions that are excluded from the definition of "Asset Sale." • Asset sale proceeds generally don't have to be spent within 365 days (or other specified time period) as long as a binding contract is in place within such time period, and the proceeds are in fact spent during a subsequent 180-day period.
	ASIA	Under high-yield notes issued by PRC-based issuers, the asset sale test often includes an additional requirement that the issuer meet the fixed charge coverage ratio in connection with any sale of a restricted subsidiary, division or line of business. High-yield notes issued by PRC-based issuers often restrict restricted subsidiaries from entering into any sale-leasebacks. Some high-yield notes issued by Indonesia-based issuers also prevent restricted subsidiaries from entering into sale-leasebacks, but allow the parent to enter into sale-leasebacks in certain circumstances. Many high-yield notes issued by Indonesia-based issuers include an additional requirement that the issuer be able to incur ratio debt for an asset disposition or sale of a restricted subsidiary, division or line of business.

		Limitation on Affiliate Transactions
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Trend to not require independent fairness opinions, relying instead on decision of independent directors. Broad exceptions to covenant, including permitted restricted payments and permitted investments.
	EUROPE	Negotiation items typically include appropriate threshold for fairness opinion. Broad exceptions to covenant, including permitted restricted payments (other than permitted investments).
	ASIA	Under high-yield notes issued by PRC- and Indonesia-based issuers, the covenant is often extended to apply to 5% to 10% stockholders.

		Limitation on Merger, Consolidation and Sale of Substantially All Assets
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Trend is to require that either the issuer could incur US$1.00 under the fixed charge coverage ratio on a *pro forma* basis, or the *pro forma* fixed charge coverage ratio is not worse or is better than prior to the transaction. Requirement for leverage ratio condition is becoming less common.
	EUROPE	Frequently negotiated item includes whether issuer must be able to incur US$1.00 under the fixed charge coverage ratio on a *pro forma* basis, or the *pro forma* fixed charge coverage ratio must be not worse or is better than prior to the transaction. Typical requirement that successor company be incorporated in "pre-expansion" (*i.e.*, pre-2003) EU country, Switzerland or United States (*i.e.*, assuming issuer is not organized in post-expansion EU country).

		Limitation on Merger, Consolidation and Sale of Substantially All Assets
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in Asia and weaker similar protection in the United States and Europe
DISTINGUISHING CHARACTERISTICS	ASIA	In addition to the typical U.S. and European market requirements, high-yield notes issued by PRC-based issuers require that (i) the issuer or the surviving entity have a consolidated net worth equal to or greater than the consolidated net worth of the issuer prior to the transaction and (ii) no rating decline has occurred. Many high-yield notes issued by Indonesia-based issuers also require the issuer or the surviving entity to have a consolidated net worth equal to or greater than the consolidated net worth of the issuer prior to the transaction. Certain high-yield notes issued by Indonesia-based issuers also require the surviving entity to be incorporated in Indonesia, Singapore or the United States.

		Change of Control
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in the United States and weaker similar protection in Europe and Asia
DISTINGUISHING CHARACTERISTICS	UNITED STATES	Ratings trigger is typical only in stronger credit issuances and sponsor deals. Portability less common than in non-U.S. jurisdictions. Recently, some deals trigger a change of control only if a leverage test is not met. Recent concern that dead hand proxy puts may be unenforceable and/or create director liability.
	EUROPE	Portability with double triggers (*i.e.*, change of control plus ratings downgrade or leverage test) is typical only in stronger credit issuances and sponsor deals.
	ASIA	Under high-yield notes issued by PRC-based issuers, double triggers are common (with the requirement that the rating downgrade event occur within six months of the change of control event). High-yield notes issued by Indonesia-based issuers may have single or double triggers.

Reporting Requirements		
	NOTEHOLDER PROTECTION LEVEL	Strongest protection in the United States with equal protection in Europe and Asia
DISTINGUISHING CHARACTERISTICS	UNITED STATES	The issuer is required to furnish all quarterly, annual or certain reports that would be required on Forms 10-Q, 10-K and 8-K, respectively. Trend to give extended cure periods to reporting defaults, sometimes with an increase in interest rate. Also trend to exclude reporting defaults from "no-default" condition to other actions such as restricted payments and debt incurrence. Another trend is for the issuer to agree to hold quarterly conference calls with investors to discuss financial results.
	EUROPE	The issuer is required to deliver annual reports 120 days after year-end, quarterly reports 60 days after each of the first three fiscal quarters, and descriptions of certain material events promptly after they occur. First-time issuers typically have 90 days for first quarterly report. Frequently negotiated and increasing focus of investors is access to and required quality/scope of reports, in particular whether reports must be substantially similar in scope and content to (Rule 144A) offering memorandum or if lower standard applies. Certain privately-held (*e.g.*, family-owned) issuers only make reports available on password-protected investor relations website.
	ASIA	High-yield notes by Asia-based issuers typically adopt the European requirements, although there is some case-by-case variation.

Fall-Away Covenants		
	NOTEHOLDER PROTECTION LEVEL	Equal protection in the United States, Europe and Asia
DISTINGUISHING CHARACTERISTICS	UNITED STATES	"Suspension" more typical than permanent "fall-away." The change of control and limitation on liens covenants are not fall-away covenants for the same reasons as in other regions.
	EUROPE	"Suspension" more typical than permanent "fall-away." The change of control and limitation on liens covenants are not fall-away covenants, as neither change of control or creation of lien for the benefit of other creditors can be later undone. "Negative pledge" also feature of (investment-grade) Eurobonds in Europe, so investment-grade status not a reason for limitation on liens covenant to fall away or be suspended.
	ASIA	"Suspension" more typical than permanent "fall-away." The change of control and limitation on liens covenants are not fall-away covenants for the same reasons as in other regions.

A Closer Look at High-Yield Bonds for Asia-Based Issuers

The preparation of high-yield bond offerings by Asia-based issuers requires attention to distinctively country-specific concerns. The offering structures and covenant packages of such offerings, consequently, vary from their U.S. and European counterparts in fundamental ways.

General Considerations for Asia-Based Issuers

Currency

The default currency for high-yield bonds offered by Asia-based issuers continues to be the U.S. dollar. However, other currency arrangements (*e.g.*, dim sum bonds and offerings in local denominations such as the Singapore dollar) are gaining traction. (Dim sum bonds are denominated in Renminbi but are issued outside of the PRC.)

Rating Enhancements

In structuring an offer by an Asia-based issuer, it is important to attend to ways in which the structure can enhance the offering's ratings. The following enhancements can improve the ratings of high-yield bonds offered by Asia-based issuers: (i) pledge of collateral; (ii) offshore escrow of proceeds; (iii) third-party guarantees; (iv) debt service reserve or proceeds accounts; (v) amortization schedule; (vi) equity sweetener such as warrants; and (vii) pledge of offshore assets and revenues.

Offering Type

The choice between a Rule 144A offering and a Regulation S offering is not solely dictated by the offering size. For example, the target investor base is an important factor to consider. Offerings by higher-rated PRC property companies can be sold exclusively to Asian private banking clients, while lower-rated issuers can be targeted to a more specialized investor base in the United States. Additionally, attention should be given to the necessary lead time. Rule 144A offerings take longer than Regulations S offerings to come to the market because Rule 144A offerings are subject to more extensive due diligence procedures and disclosure requirements. See *Legal Considerations — Transaction Structure and U.S. Federal Securities Law — Rule 144A*.

Key Considerations for Offerings by PRC Issuers

Credit Support and Structural Subordination

Under the PRC's regulatory scheme, it is virtually impossible for an operating company that is not a state-owned enterprise (*i.e.*, an offshore holding company) to obtain the PRC approvals necessary to guarantee securities offered to non-PRC investors. As a result, high-yield bonds issued by PRC-based issuers are deeply structurally subordinated because the high-yield noteholders rank junior to creditors of the Issuer's PRC subsidiaries. The usual remedy for structural subordination is to require upstream guarantees from operating subsidiaries. See *Subordination — Structural subordination*. In the PRC, that necessitates upstream guarantees from all of the Issuer's existing and future non-PRC subsidiaries.

However, the effectiveness of such upstream guarantees may be limited for the following reasons:

- Guarantees may be challenged by other creditors on the grounds of fraudulent conveyance if the subsidiary guarantor did not receive reasonably equivalent value for the guarantee;
- Existing lenders or minority shareholders may be prohibited from providing guarantees pursuant to existing agreements;

- If a subsidiary has significant minority shareholders, such minority shareholders may object to a guarantee by such subsidiary; and
- Subsidiaries cannot guarantee the bonds if they are deemed to be investment companies pursuant to the United States Investment Company Act of 1940, as amended.

Security

The preferred method of using hard asset collateral to pledge as collateral for the bonds is typically not available. PRC regulatory restrictions prohibit shares and assets of PRC operating companies from being pledged as security for offshore debt. While the shares of offshore intermediate holding companies are instead pledged in PRC deals, a foreclosure on such shares does not allow the noteholders to control the onshore PRC operating companies where the assets and revenues sit. As such, some high-yield bond offerings by PRC-based issuers have omitted share pledges.

Covenant Package

Because high-yield bonds issued by PRC-based issuers are deeply structurally subordinated, the covenant packages are designed to minimize the incurrence of onshore debt that is structurally senior to the offshore high-yield bonds. See — *Credit Support and Structural Subordination*. However, due to the business reality in the PRC, many high-yield issuers require substantial flexibility – even when they are already highly leveraged. Accordingly, the covenant packages are designed to permit such issuers to incur substantial additional onshore debt through purchase money and other exceptions tied to a percentage of total assets that grows with the business.

Key Considerations for Offerings by Indonesian Issuers

Withholding Tax

Withholding tax is a key component in the structuring of high-yield bonds issued by Indonesia-based issuers. Under Indonesian laws, payments of principal under high-yield bonds are not subject to withholding tax, but

interest income sourced from Indonesia is subject to withholding tax absent an applicable tax treaty that will act to reduce such tax. Because withholding tax rates can be as high as 20% in Indonesia, issuers are incentivized to minimize withholding taxes or gross up payments. To understand the current approaches being used by Indonesia-based issuers, a quick history of the evolution of tax-efficient structures provides helpful background.

Indonesian tax laws and regulations generally require a 20% income tax to be withheld on the payment of interest or when it is due (whichever comes first) to an offshore tax resident, which does not have a permanent establishment in Indonesia. Under the double tax treaty between Singapore and Indonesia (the "Singapore-Indonesia Tax Treaty"), the rate of withholding tax on interest is reduced to 10% when it is paid or due (whichever comes first) to a Singapore tax resident which is the beneficial owner of this interest.

On January 1, 2004, a tax treaty between Indonesia and the Netherlands became effective whereby the withholding tax rate of interest payments became 0% (as opposed to the previously prevailing rate of 10%) if:

- the interest income recipient does not have a permanent establishment in Indonesia;
- the interest was paid on loans with a term greater than two years; and
- the interest income recipient is the beneficial owner of the interest.

As mentioned above, under the Singapore-Indonesia Tax Treaty the rate of withholding tax on interest is reduced to 10% provided the interest is paid or due to a Singapore tax resident which is the beneficial owner of this interest. As a result, many Indonesia-based issuers have established special purpose vehicles ("**SPVs**") in the Netherlands or Singapore to reduce exposure to Indonesian withholding tax and issue the bonds through the SPVs with guarantees from the Indonesian parent and its operating subsidiaries. In 2017, Indonesia and the Netherlands signed a protocol to their existing tax treaty, based on which the interest withholding tax rate is increased from zero to 5%, provided that the abovementioned three conditions are satisfied.

In November 2009, the Indonesian tax authorities issued Regulations 61 and 62 (the "**Regulations**") which aim to avoid abuse of Indonesia's tax treaties. Based on the Regulations, Indonesia will not honor the benefits

under its tax treaties if the overseas tax treaty company does not have sufficient substance and business purpose, as certified in the required form by a director of the overseas tax treaty company.

On June 19, 2017, the Indonesian tax authority replaced the Regulations by a new regulation ("**DGTR/10**") in which the Indonesian tax authorities further tightened the substance conditions in order to enjoy tax treaty benefits under Indonesia's tax treaties.

As such, in order to qualify for the benefits under the tax treaties, the Issuer must demonstrate that:

- one of the main purposes why the interest income recipient is established in the tax treaty country is not to obtain treaty benefits,
- the interest income recipient has independent management and its own employees,
- sufficient assets,
- the interest income recipient has an active operation or business, and
- 50% or more of the recipient's income from Indonesia is not used to satisfy an obligation to another party in a form of interest, royalty or other reward.

These requirements mark another step in the evolution of the Indonesian tax authorities requiring a presence in the tax-preferred jurisdiction before being able to take advantage of the double taxation treaty and special care must be taken to ensure that the overseas tax treaty company satisfies the requirements under DGTR/10.

Consequently, Indonesia-based high-yield issuers tend to use one of the following structures to minimize withholding taxes while complying with Indonesian tax regulations:

- **Double-decker structure or dual-issuer structure** – under this structure, the Indonesian parent company establishes two companies in the Netherlands or Singapore. One of the two entities is an SPV that issues the bonds and contributes the proceeds of such offering to a direct, wholly-owned operating company, which, in turn, on-lends the proceeds to the parent company through an intercompany loan

- **Netherlands company structure** – under this structure, the Indonesian parent company establishes a Netherlands SPV as the Issuer which contributes the proceeds as equity to its Netherlands operating company subsidiary, which enters into a loan agreement with the Indonesian borrower.
- **Singapore company issuer structure** – under this structure, the Indonesian parent company establishes a Singapore company that issues the bonds and partly on-lends the proceeds to the subsidiary operating company through an intercompany loan, and contributes the other part as equity to this company.

It is unclear if these structures explicitly comply with the requirement that 50% or more of the interest income recipient's income not be used to satisfy an obligation to another party in a form of interest, royalty or other reward. Arguably this may be the case. Advocates of the Singapore structure rely on the notion that the Singapore entity will be taxed at a higher withholding tax rate of 10% such that tax authorities will not review the structure as they are more likely expected to do in the Netherlands structure.

Singapore Tax Implications

In order for the 10% tax treaty rate to be applicable, the Singapore-Indonesia Tax Treaty requires the interest to be remitted into Singapore by the Indonesian borrower.

Under Singapore income tax law, an issuer would be considered tax resident in Singapore if the control and management of its business is exercised in Singapore. As a general rule, the place where a company's control and management is exercised and hence the tax residence of the company is the place where the directors of the company hold their meetings. In order to obtain a tax residency certificate from the Singapore tax authorities certifying that the Singapore recipient of the interest is a tax resident of Singapore (a requirement under the Singapore-Indonesia Tax Treaty), the IRAS will require the Singapore company to have certain minimum substance in Singapore.

Comparatively, tax residency in Indonesia is determined based on the location of "incorporation" or "domicile." Another matter that must be addressed is that Singapore imposes a withholding tax of 15% on interest paid by a Singapore company to overseas lenders unless this is reduced

under a favorable tax treaty or exempted under domestic tax law. Under domestic tax law, the withholding tax may be exempted if the Singapore borrower issues a bond which is substantially arranged in Singapore.[5]

Indonesia Tax Implications

In addition, the reduced tax rate is available to a Singapore company only if the company is able to comply with the requirements stipulated in DGTR/10 regarding the application of double taxation treaties. As mentioned above, the introduction of DGTR/10 has provided additional substantive requirements for issuers to fulfill the criteria of a beneficial owner.

Furthermore, the Minister of Finance of Indonesia recently issued a new regulation updating the Indonesian Controlled Foreign Company rule, effective as of fiscal year 2017. The Indonesian tax authorities have not issued guidelines detailing the implementation of the new CFC rule. Consequently, the after-tax profit of the Issuer would contribute to the parent guarantor's taxable income.

Material Transactions

On November 28, 2011, OJK Regulation IX.E.2 on Material Transactions and Change of Core Business was issued, which replaced the previous regulation issued in 2009 (the "**Material Transactions Regulation**"). This regulation is applicable to publicly listed companies in Indonesia and their unlisted consolidated subsidiaries. Pursuant to the Material Transactions Regulation, each borrowing and lending in one transaction or a series of related transactions for a particular purpose or activity having a transaction value of 20% to 50% of the publicly listed company's equity, as determined by the latest audited annual financial statements, semi-annual reviewed financial statements or audited interim financial statements (if any), must be announced to the public and the listed company must also prepare an appraisal report.

The announcement relating to the material transaction must be made to the public in at least one Indonesian language daily newspaper having national circulation no later than the end of the second business day after the date of execution of the agreement(s) related to the material transaction.

5 The bond must be a Qualifying Debt Security (QDS).

The announcement is required to include a summary of the transaction, an explanation of the considerations and reasons for such material transaction and the effect of the transaction on the company's financial condition, a summary of the appraisal report (including its purpose, the object, the parties involved, the assumptions, qualifications and methodology used in the appraisal report, the conclusion on the value of the transaction, and the fairness opinion on the transaction), which must not be dated more than six months prior to the date of the material transaction, the amount borrowed and a summary of the terms and conditions of the borrowing. Publicly listed companies must submit evidence of an announcement as referred to above, including the independent appraisal report to OJK at the latest by the end of the second business day after the date of execution of the agreement(s) related to the material transaction.

Subject to certain exceptions under the Material Transactions Regulation, a material transaction (in this case, borrowing and lending) with a value in excess of 50% of a company's equity must be approved by shareholders holding more than half of all shares with valid voting rights who are present or represented, and more than half of such shareholders present or represented approve the transaction, in addition to fulfilling the appraisal disclosure requirements.

Security

The practicalities of the court system in Indonesia, which can serve to limit access to justice for offshore creditors, have resulted in hard asset onshore collateral typically being under-valued by investors due to significant enforcement difficulties. As a result, many Indonesia-based high-yield bond offerings are unsecured. However, if an issuer has access to offshore receivables or other sources of revenue, offshore account security is often used to provide valuable collateral to support a transaction structure as well as to reduce the foreign exchange exposure as such receivables are often denominated in U.S. dollars.

Legal Considerations

Governing Law

The terms and restrictive covenants of high-yield bonds are set forth in an indenture, which is typically governed by New York law. Pursuant to the indenture, a trustee is appointed to represent the interests of noteholders. Extensive New York case law provides both the Issuer and the noteholders with a relative degree of certainty regarding the interpretation of the high-yield covenants and legal issues associated with the bonds and the indenture. This depth of applicable case law, which serves as a robust interpretative protection in a default or dispute, means that New York law remains the preferred choice of governing law for high-yield bonds.

The governing law, however, should be discussed among the Issuer, the underwriters and their respective counsels at the outset of the transaction and attention should be paid to marketability considerations and the target investor audience for the particular offering (*i.e.*, depending on the particular issuer and current state of the market, U.S. investors may be a key target investor group and such investors will demand New York law). Irrespective of the governing law, the substance and drafting of high-yield bond covenants is substantially similar.

Transaction Structure and U.S. Federal Securities Law

Section 5 of the United States Securities Act of 1933, as amended (the "**Securities Act**"), prohibits the offer and sale of securities to any person unless a registration statement (including a prospectus that

meets statutory requirements) has been filed with the SEC and become effective or unless an exemption from such registration is available. Substantially all high-yield bond offerings are conducted as private placements (i) in the United States through a combination of Section 4(a)(2) of the Securities Act and Rule 144A under the Securities Act ("**Rule 144A**") and (ii) outside of the United States in reliance on Regulation S under the Securities Act ("**Regulation S**"). This is generally true whether the Issuer is private or already a public reporting company, largely due to the fact that registration involves delays and the target market for high-yield bonds is principally mutual funds, insurance companies, pension funds, hedge funds and other large financial organizations that qualify as qualified institutional buyers ("**QIBs**") as to which the availability of Rule 144A mitigates the negatives typically associated with holding "restricted securities."[6]

Section 4(a)(2)

The first step in the bond offering is the sale of the bonds from the Issuer to the initial purchasers (*i.e.*, the underwriters) through a private placement of the bonds under Section 4(a)(2) of the Securities Act, which exempts transactions by an Issuer not involving a public offering. Immediately following the sale of the bonds to the initial purchasers, the initial purchasers resell the bonds to QIBs under Rule 144A and to persons outside the United States pursuant to Regulation S.

Rule 144(A)

Rule 144A provides a safe harbor that permits resales of securities only to QIBs. QIBs include various enumerated categories of sophisticated institutional investors with at least US$100 million of securities of non-affiliates under management, banks or savings and loan associations that own and invest at least US$100 million of securities of non-affiliates and that have an audited net worth of at least US$25 million, as well as SEC-registered broker-dealers owning and investing at least US$10 million in securities of non-affiliates.

6 For a variety of reasons, including the relative simplicity of a private placement followed by a subsequent A/B exchange off (discussed below), high-yield debt offerings are infrequently done "off the shelf" (*i.e.*, utilizing a shelf registration statement that has been previously filled with, and declared effective by the SEC.

In addition, to be eligible for the Rule 144A safe harbor, purchasers must be notified that a proposed sale is being made pursuant to Rule 144A (typically by way of appropriate legends and disclaimers in the offering memorandum) and the relevant securities must (i) not be of the same class as securities listed on a U.S. exchange or quoted on a U.S. automated inter-dealer quotation system (*e.g.*, NASDAQ), (ii) not be convertible or exchangeable into listed or quoted securities with an effective premium of less than 10% and (iii) not be issued by an open-end investment company.

Holders of the relevant securities and prospective purchasers must have the right to obtain from the Issuer certain reasonably current information about the Issuer. Because resales of securities pursuant to Rule 144A (like any other offers and sales of securities in the United States) are subject to the liability and anti-fraud provisions under the U.S. securities laws (including Rule 10b-5 under the United States Securities Exchange Act of 1934, as amended (the "**Exchange Act**")), it is market practice to provide disclosure in connection with a Rule 144A offering that is substantially similar to the disclosure required for an SEC-registered offering, both in terms of quality and scope. Accordingly, the due diligence exercises conducted by the working group in a Rule 144A transaction are robust and very similar to the due diligence that would be conducted by the working group in a registered offering. See *Documentation — Legal Opinions and Disclosure Letters.*

Regulation S

Regulation S provides a safe harbor from the registration requirements of Section 5 of the Securities Act for certain offerings outside the United States and offshore resales of securities. If the conditions of Regulation S are met, the transaction is deemed to take place outside of the United States and does not trigger the registration requirements of Section 5 of the Securities Act.

Under Regulation S, an offer or sale of securities is deemed to occur outside the United States if (i) the offer or sale is made in offshore transactions and (ii) no directed selling efforts are made in the United States by the Issuer, the underwriters, any other distributor, any of their respective affiliates or any person acting on their behalf.

An offshore transaction is defined as an offer that is not made to a person (which includes entities) in the United States and either:

- at the time the buy order is originated, the buyer is outside the United States or the seller and any person on the seller's behalf reasonably believes that the buyer is outside the United States;
- the transaction is executed in, on or through the physical trading floor of an established foreign securities exchange located outside of the United States (for Issuer safe harbor); or
- the transaction is executed in, on or through the facilities of a designated offshore securities market and neither the seller nor any person on the seller's behalf knows the transaction has been prearranged with a buyer in the United States (for resale safe harbor).

Directed selling efforts means any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the U.S. market for any of the securities being offered in reliance on Regulation S. It is therefore necessary for the counsel involved in an offering to analyze any relevant activity or communication in terms of its audience, timing and content as well as in light of both the various exceptions included in the definition of directed selling efforts and the relevant SEC staff positions.

PRACTICE TIP

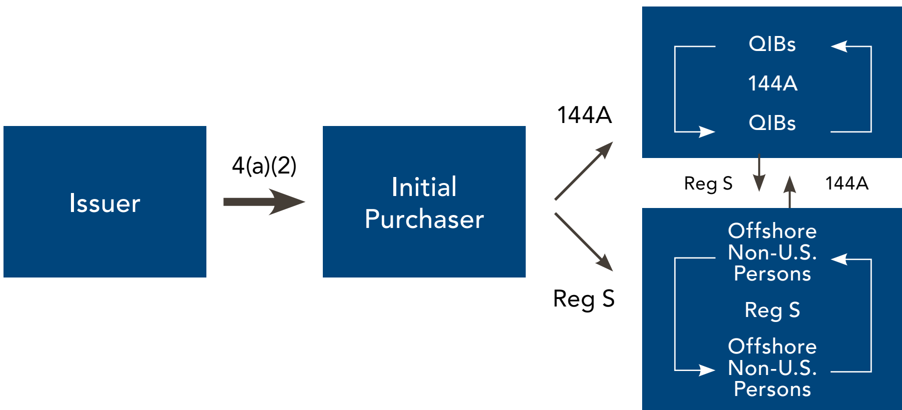
It is important to determine with the underwriters as early as possible whether a transaction will be structured as Regulation S-only or Regulation S/Rule 144A offering as this offering structure will impact the due diligence and disclosure requirements, among other things, and the overall transaction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

In order to qualify for a given safe harbor under Regulation S, certain additional requirements, such as the implementation of additional offering restrictions and the imposition of a distribution compliance period, may have to be met as well. These requirements vary depending principally on the status of the Issuer and the likelihood of the bonds issued outside of

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

- Category 1 (least restrictive): Category 1 transactions include offerings of securities by foreign issuers that reasonably believe at the commencement of the offering that there is no substantial U.S. market interest ("**SUSMI**") with respect to the relevant securities to be offered or sold; securities offered and sold securities by either a "foreign issuer" or, in the case of non-convertible debt securities, a U.S. issuer, in an overseas directed offering; securities backed by the full faith and credit of a foreign government or sovereign, including securities issued directly (or guaranteed) by a foreign government or sovereign or a political subdivision thereof; and securities by foreign issuers pursuant to an employee benefit plan established under foreign law. For these transactions, it is unlikely that the securities offered will flow into the U.S. market and no other requirements need to be met other than the Regulation S basic conditions;
- Category 2: Category 2 transactions include offerings of equity securities of a reporting foreign issuer; debt securities of a reporting U.S. or foreign issuer; and debt securities of a non-reporting foreign issuer. For these transactions, certain offering restrictions must be adopted, including that no offers or sales may be made to a U.S. person or for the account or benefit of a U.S. person during a 40-day distribution compliance period; and
- Category 3 (most restrictive): Category 3 transactions include transactions not eligible for Category 1 or Category 2. For these transactions, existing potential U.S. market interest is sufficient enough (*i.e.*, there is SUSMI with respect to the relevant securities) to suggest that offerings of the Issuer's securities outside the United States may not come to rest abroad. All of the Category 2 restrictions must be adopted (with further distribution compliance period restrictions) and certain purchaser certifications and others restrictions must be satisfied.

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



Registered Exchange Offers Versus Private-For-Life

The initial private placement of the bonds and subsequent resale pursuant to Rule 144A or Regulation S result in the noteholders holding restricted securities. However, holding restricted securities is problematic for a subset of investors who are not permitted to hold unlimited amounts of restricted debt securities, due to internal policies, provisions in operating agreements or regulatory restrictions. Restricted securities held by non-affiliates of the Issuer are generally subject to a six-month holding period for Issuers subject to Exchange Act reporting requirements or a one-year holding period for non-reporting Issuers before the restricted securities may be resold without restriction pursuant to Rule 144 of the Securities Act. However, the noteholders may sell the bonds prior to meeting the Rule 144 holding period requirements to other QIBs pursuant to Rule 144A and to foreign investors under Regulation S.

Historically, with a view to broadening the marketing and distribution of the bonds to as many eligible investors as possible, it is commonplace for issuers of high-yield bonds to enter into a registration rights agreement with the initial purchasers of the bonds at the closing of the offering in which the Issuer agrees to engage in what is known as an "A/B exchange offer" within a certain time period after the issuance of the bonds. Pursuant to guidance provided by the SEC in certain no-action letters (including the Exxon Capital no-action letter in which the SEC initially approved the procedure), an A/B exchange allows the Issuer to exchange debt securities initially issued in a private placement for identical new securities in an offering registered with the SEC. The registration rights agreement will require the Issuer to file a

registration statement (on Form S-4) for the A/B exchange within a certain period of time following the issuance of the original bonds and to have the registration statement declared effective by the SEC within an additional number of days or otherwise be subject to penalties in the form of additional interest until the SEC declares the registration statement effective. The time period to conduct the exchange offer varies greatly (from 120 days to 365 days, depending on the nature of the Issuer). Payments of additional interest typically continue until the earlier of the exchange offer or an outside date (which varies depending on the time period allowed for consummating the exchange).

The exchange offer registration statement will be virtually identical to the offering memorandum but updated accordingly for the passage of time and describing the mechanics of the A/B exchange offer and related issues. The SEC may review and comment on the registration statement and often will for first-time registrants. If the Issuer is not already a public company, the A/B exchange offer will also be attractive to investors because as a consequence of issuing registered bonds, the Issuer will become subject to SEC rules and regulations, including the requirement to file periodic and current reports (*i.e.*, Forms 10-K, 10-Q and 8-K), thus ensuring a steady flow of financial and other information mandated by the SEC to the noteholders and the investing public. Companies that are not public must balance these marketing benefits against the additional cost of becoming a public company, including increased reporting requirements and liability, as well as any negative effects that being a public reporting company by virtue of a registered debt offering may have on the company's future plans, such as an initial public offering of equity securities (*i.e.*, a traditional IPO). Weighing these factors, private companies often elect to issue the bonds as "private-for-life" or "144A-for-life," that is, without any registration rights or other requirement that the Issuer become a reporting company.

The registration rights agreement that evidences the obligation of the Issuer to engage in the A/B exchange also generally requires that the Issuer file a shelf registration statement to permit SEC-registered resales of the bonds under certain circumstances, such as if the exchange offer cannot be consummated due to a change in law or SEC policy or if a noteholder isn't eligible to participate in the exchange offer because it is an affiliate of the Issuer.

A further consideration for both public and private companies is the applicability of the Trust Indenture Act of 1939 (the "**TIA**"). The purpose of the TIA is to protect noteholders and to curb perceived abuses by companies and underwriters in issuing debt securities. Debt securities issued in private placements exempt from registration under Section 4(a)(2) of the Securities Act are not subject to the TIA; however, bonds that are registered, including bonds that are issued in an A/B exchange offer, are subject to the TIA. The TIA contains numerous requirements applicable to trustees, issuers and the terms of the indenture that governs the bonds, and many of these requirements are adopted in indentures used in Asia-based offerings. In particular, in the case of secured bonds, the TIA has certificate and opinion requirements applicable to releases of collateral that can be cumbersome and expensive, particularly for first-lien secured bonds.[7]

More recently, the operation of Section 316(b) of the TIA has been called into question by several decisions out of New York. Section 316(b) requires the consent of each noteholder when seeking to impair or adversely affect the right of such noteholder to receive payment of principal or interest. Previously, Section 316(b) was thought to protect against only involuntary modification of payment terms or a noteholder's right to sue for payment; however, in recent decisions, New York courts, looking to legislative history, have expanded the provision to also protect against actions by the Issuer, whether or not involving a modification of the terms of the bond or the indenture, that might lead to the noteholders receiving a lesser payment than was originally bargained, at least outside of a court supervised restructuring. Uncertainty associated with the proper application and interpretation of these decisions has led to an increase in private-for-life bond offerings, as well as modifications to the relevant provisions of indentures used in these offerings.

Publicity Restrictions

The securities laws of many jurisdictions, in particular the United States, impose various restrictions on publicity and the release of information generally in connection with a proposed offering of securities. Publicity for this purpose can be construed very broadly and may include any form of communication, whether in written, oral or electronic form,

7 The SEC has granted no-action relief in the case of bonds secured by second priority (or lower) liens that lessens the compliance burden of such provisions.

that (i) relates to or concerns the offering, (ii) relates to the performance, assets, liabilities, financial position, revenues, profits, losses, trading record, prospects, valuation or market position of the Issuer, (iii) might affect an investor's assessment of the financial position and prospects of the Issuer or (iv) otherwise has the purpose, or reasonably could have the effect, of conditioning the market in a particular jurisdiction or influencing or encouraging an investor's interest in the Issuer, the offering, or a decision to purchase the securities in question.

The release of information that is inaccurate, misleading or inconsistent with the offering memorandum is undesirable, as it may cast doubt on the accuracy of the offering memorandum. Failure to observe publicity requirements may result in registration or similar requirements under the securities laws of various jurisdictions and imposition of a cooling-off period and may result in the offering not being completed. As such, careful attention to publicity is imperative to the successful and timely completion of an offering. A common problem is information on the Issuer's website. Therefore, the Issuer's website should be scrubbed before the deal to remove all information that is inaccurate, misleading or inconsistent with the offering memorandum. Additionally, the Issuer should avoid posting information on its website during the course of the offering without consulting with legal counsel and the working group.

To ensure compliance with all applicable securities laws and regulations, the Issuer's counsel will prepare publicity guidelines at the outset of a proposed offering. The guidelines may be reviewed by the underwriters' counsel and must be adhered to by all offering participants. While all Issuer representatives and other offering participants that are likely to be approached by, or come in contact with, the press or securities analysts during the course of the offering should be familiar with the publicity guidelines, it is advisable to appoint one Issuer representative to serve as the initial point of contact with the press and securities analysts and to handle publicity and other broad-based communications during the offering process.

PRACTICE TIP

Publicity restrictions should be implemented very early in the process and in most cases should be in place shortly after the transaction kicks off.

Transaction Execution

Pre-Launch

Under ideal circumstances and with the full commitment of all parties involved in the offering, the preparations for a high-yield bond offering for a first-time Issuer can be completed within approximately six to ten weeks from the initial kick-off meeting to the offering launch (*i.e.*, the formal external announcement of the proposed offering). Factors that cause delays include: (i) the lack of existing, high-quality, English language disclosure language regarding the Issuer and its business that can be tailored for purposes of the offering memorandum, (ii) the time needed by Issuer's internal accounting team and external auditors to prepare the required financial information, (iii) complications and delays in any necessary negotiations with existing creditors of the Issuer, (iv) complexities involved in releasing existing security interests (in favor of creditors that are being repaid) and in creating new security interests (in favor of the noteholders), (v) delays and complications in the rating process; (vi) third-party KYC procedures and (vii) general market conditions.

The table below details a typical pre-launch timeline:

Time	Tasks
Week 1	• Issuer's counsel prepares initial offering memorandum outline and discusses it with issuer. • Issuer, underwriters and their respective counsels agree to the offering structure. • Issuer and issuer's counsel discuss covenant package. • Issuer's counsel discusses covenant concerns with underwriters. • Issuer prepares data room in response to due diligence request list provided by issuer's counsel and underwriters' counsel. • Underwriters circulate management due diligence questionnaire. • Issuer's counsel circulates publicity guidelines. • Underwriters' counsel circulates research guidelines.
Week 2	• Issuer circulates management presentation to working group. • Issuer, underwriters and their respective counsels agree to approach with respect to existing lenders and security trustee. • Working group provides high-level feedback on draft offering memorandum. • Issuer and issuer's counsel revise draft offering memorandum. • Issuer's counsel and underwriters' counsel commence documentary due diligence. • Underwriters and underwriters' counsel draft description of the notes and note documentation.
Week 3	• Select stock exchange for listing notes. • Select trustee and trustee's counsel. • Issuer's counsel re-circulates offering memorandum draft. • Underwriters' counsel circulates draft description of the notes. • Draft documentation for trustee accession arrangements to existing security (if applicable). • Underwriters and underwriters' counsel review draft offering memorandum and prepare consolidated mark up. • Issuer and issuer's counsel discuss description of the notes. • Drafting session on draft offering memorandum. • Draft accountant engagement and comfort letters circulated. • Underwriters and underwriters' counsel circulate draft purchase agreement. • Issuer and underwriters prepare rating agency presentation. • Issuers, underwriters and their respective counsels further discuss approach with respect to existing lenders and security trustee, if necessary.

Time	Tasks
Week 4	• Issuer's counsel re-circulates offering memorandum to working group. • Issuer's counsel circulates mark up of description of the notes. • Underwriters and underwriters' counsel review draft offering memorandum and prepare consolidated mark up. • Underwriters, issuer and their respective counsels discuss description of the notes. • Drafting session on draft offering memorandum. • Issuer and issuer's counsel discuss purchase agreement and circulate mark up to underwriters and underwriters' counsel. • Issuer and underwriters prepare rating agency presentation.
Week 5	• Drafting session on draft offering memorandum, if necessary. • Discussions on description of the notes (including with trustee and trustee's counsel) and trustee note accession arrangements. • Discuss purchase agreement, if necessary. • Issuer and underwriters prepare rating agency presentation. • Work on road show presentation.
Week 6	• Issuer submits draft offering memorandum to stock exchange and sends it to printers (if it is sufficiently advanced). • Drafting session on draft offering memorandum, if necessary. • Discuss purchase agreement, if necessary. • Meetings with rating agencies. • Work on road show presentation.
Week 7	• Issuer receives stock exchange comments to the draft offering memorandum, incorporates such comments and resubmits draft offering memorandum to exchange. • Underwriters' counsel finalizes description of the notes. • Discuss purchase agreement, if necessary.
Week 8	• Issuer's counsel finalizes preliminary offering memorandum, including with stock exchange • Finalize purchase agreement • Finalize road show presentation • Security trustee and any lender consents obtained • Receive preliminary feedback from rating agencies • Print preliminary offering memorandum

The Due Diligence Review

General Guidelines

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

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

Conducting Due Diligence

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

A legal and business due diligence review includes a review of the Issuer's corporate structure and organization, board minutes, finance and accounting procedures, shareholder information, presentations and reports from the Issuer, material agreements, intellectual property, tax issues, assets, environmental issues, current and pending litigation, strategy, competition and industry outlook. The underwriters and their counsel provide the Issuer with a list of documents that they would like to review in preparation of the offering memorandum. This due diligence request list is comprehensive and broad. As the requesting party is not fully apprised of the Issuer's documentation, the list necessarily includes items that an underwriter would normally expect to find in the data room of a similar company in a similar industry.

After receiving a diligence request list, the Issuer begins preparing a data room containing documents responsive to the diligence request list as well as any documents not on the diligence request list but deemed by the Issuer to be material. The location of the data room itself varies, based on the location of the documents and the parties that need to review the documents. For most issuers, it is more efficient and economical to make the documents available for review via a secure, password-protected website, accessible only to those parties involved in the offering. For certain issuers, it is most efficient and economical to set up a space at their place of business where all of the documents can be set aside for review. The Issuer's international legal counsel can assist the Issuer's management team to interpret the due diligence request list as well as provide advice regarding how to best organize the materials for the working group.

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

During the due diligence and drafting processes, management and due diligence meetings are conducted with senior management of the Issuer. These meetings afford the underwriters and both sets of legal counsel the opportunity to understand the Issuer's business so as to create the offering memorandum.

"Rule 10b-5 Letter"

The due diligence review also serves to establish a record that the underwriters have made a reasonable investigation upon which their defense against potential liability can be based. Offerings made under

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

Documentation

Offering Memorandum

The offering memorandum is a disclosure document intended to provide potential investors with all material information necessary to make informed investment decisions and contains information similar to the information set forth in a prospectus for a public offering. In addition to providing potential investors with information about the proposed offering, the offering memorandum serves to protect both the Issuer and the initial purchasers from liability under applicable securities laws for alleged material misstatements or omissions in connection with the offer and sale of the bonds.

The key disclosure items in the offering memorandum are:

- *Offering summary or "box:"* The initial purchasers and potential investors focus on the box, which has a marketing focus and provides (i) an issuance overview, (ii) a business description (including business strategies and competitive strengths), (iii) the corporate and transaction structure and (iv) summary financial data.

- *Risk factors*: The risk factors section specifies the risks associated with the Issuer and its industry and risks related to the bonds and the private placement. The risk factors are often similar to risk factors found in offering memoranda and prospectuses of other Issuers in the same industry and are tailored to describe the specific risks associated with the company conducting the present offering. Per guidance from the SEC, risk factors should not contain any mitigating language with respect to the particular risk being described.
- *Use of proceeds*: The use of proceeds section summarizes the sources and uses of the funds being raised by the offering, as well as any other sources of capital.
- *Capitalization*: The capitalization section sets forth the Issuer's actual and *pro forma* capitalization to reflect the proceeds raised in the offering and application of the net proceeds.
- *Financial statements*: the Issuer is required to include audited and reviewed financial statements (prepared in accordance with international financial reporting standards (IFRS), the Issuer's home country's generally accepted accounting principles (GAAP) or U.S. GAAP) including a balance sheet (typically the end of the two most recent fiscal years and most recent interim period) and statements of income, cash flows and stockholders' equity (typically the three most recent fiscal years and most recent interim period and comparable prior year interim period). The Issuer will also include selected financial data for the past five years in the offering memorandum.

The preparation and audit of financial statements will require a significant amount of time, particularly for Issuers that are not subject to the reporting requirements of the Exchange Act or that have not presented audited financial statements in the past. An Issuer that does not have current audited financial statements should start the process as early in the preparation period as possible. Described below are additional aspects related to the Issuer's financial statement presentation that Issuers should be aware of and consider at the outset of an offering.

Rule 3-05 of Regulation S-X requires the Issuer to provide separate financial statements of companies the Issuer has acquired or that it is probable that

the Issuer will acquire if the acquired company meets any of the three significance tests:

- the "income test" compares the Issuer's equity in the target's income from continuing operations before taxes, extraordinary items and cumulative effect of a change in accounting principle to such income of the Issuer for the most recently completed fiscal year;
- the "investment test" compares the GAAP purchase price of the target to the Issuer's consolidated assets as of the end of the most recently completed fiscal year; and
- the "asset test" compares the Issuer's share of the total assets of the acquired business to the Issuer's consolidated total assets.

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

Additionally, Article 11 of Regulation S-X requires that the Issuer provide separate *pro forma* financial statements in the event a significant acquisition has occurred during the current fiscal year or is probable to occur. The *pro forma* presentation provides investors with the financial information of the combined company as if the acquisition had occurred at the beginning of the applicable period and shows the impact of the transaction on the Issuer's financial statements. The *pro forma* financial statements will include a *pro forma* balance sheet as of the end of the most recent period required by Rule 3-01 of Regulation S-X and a *pro forma* income statement for the most recent fiscal year and the most recent interim period.

PRACTICE TIP

Determination by the working group (*i.e.*, auditors, underwriters, Issuer and counsels) of the financial statements to be included in the offering memorandum should be made as early as possible so that the scope of due diligence and disclosure and comfort letter deliverables are clear to all parties and can be managed appropriately to meet the targeted timeline.

In addition, Rule 3-10 of Regulation S-X requires that the Issuer provide separate financial statements for each subsidiary of the Issuer that is a guarantor of the bonds unless (i) the subsidiary is wholly owned by the Issuer, (ii) the guarantees are joint and several, (iii) the guarantees are full and unconditional and (iv) the Issuer's financial statements contain a footnote that includes condensed consolidating financial information with a separate column for the parent company, the subsidiary guarantors on a combined basis, any other subsidiaries of the Issuer on a combined basis, consolidating adjustments and the total consolidated amounts. Rule 3-10 contains a similar rule for an Issuer that is a finance subsidiary that is issuing bonds guaranteed by its parent company, which also provides exceptions that are similar to the exceptions applicable to subsidiary guarantors.

Rule 3-16 of Regulation S-X requires that the Issuer provide separate audited and interim financial statements for any affiliate of the Issuer if the Issuer is issuing registered bonds that are secured by securities of the affiliate and the securities being pledged constitute a substantial portion of the collateral that secures the registered bonds that are issued. The securities will be deemed to constitute a substantial portion of the collateral if the aggregate amount of the securities is 20% or more of the collateral securing the bonds. Rule 3-16 will apply to both registered securities, as well as any unregistered securities with registration rights. While Rule 3-16 should be considered, secured high-yield offerings that fall into this category are not typical.

- *Management's Discussion and Analysis (MD&A)*: The MD&A section details the Issuer's financial performance through the eyes of the Issuer's management team from both a historical perspective and the Issuer's future expectations. The MD&A discussion will analyze and discuss the Issuer's financial performance on a period-by-period comparison basis and explain the reasons for differing results, as well as performance trends. The Issuer will also discuss its liquidity and capital resources, including the Issuer's expected use of the funds being raised in the high-yield offering. The MD&A should also discuss the Issuer's exposure to risks associated with the marketplace in general and commodity prices and interest rate risks.
- *Business*: This section discusses the Issuer's business, its industry and related competition, its strategies and strengths, its operations, and its products and services, as well as other areas that are specific to the Issuer's business;

- *Management overview*: The management section sets forth specific information regarding each of the Issuer's directors and key management members, including compensation matters, individual experience and education, as well as any related party transactions between the Issuer and its officers, directors and significant stockholders.
- *Description of Other Indebtedness*: This section provides an overview of the Issuer's existing debt, including its credit facilities and other indebtedness.
- *Description of the Notes (DoN)*: The DoN discusses the specific terms and conditions of the notes and summarizes the indenture. For a more detailed discussion of the DoN, see *General Observations and The High-Yield Bond Covenant Package*.
- *Other Sections*: The offering memorandum will include other sections such as the plan of distribution, restrictions on transfer, material tax considerations, outside experts or advisors, etc. In addition, certain industries, such as oil and gas, banking and real estate may require another level of industry-specific disclosure as set out under specific SEC disclosure guides. Expert reports and technical assessments may also be included in the offering memorandum.

Indenture

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

We receive numerous questions from issuers regarding the role of the trustee. Put simply, a trustee is appointed by the Issuer to represent the noteholders' interests and to administer various matters that may arise from time to time while the Notes are outstanding. These matters include purely administrative functions such as coordinating payments and receiving compliance certificates. In a pre-default scenario, the trustee will typically appoint various agents to handle paying agent, transfer agent and registrar functions. For liability management exercises, where a consent from noteholders is needed or other communication with the noteholders

becomes necessary, the trustee may be engaged to assist the Issuer with such actions through the clearing systems. In a post-default context, the trustee's role transforms to act as a fiduciary serving to preserve the noteholders' interests by declaring an event of default and taking such enforcement steps as the noteholders instruct.

Purchase Agreement

The purchase agreement is the contract between the Issuer and the initial purchasers, whereby the Issuer agrees to issue and sell the bonds to the initial purchasers and the initial purchasers agree, subject to certain conditions, to purchase the bonds from the Issuer at an agreed price at closing. Additionally, in the purchase agreement, the Issuer makes numerous representations and warranties, including with respect to its business and the completeness and accuracy of the offering memorandum, and agrees to indemnify the initial purchasers for any losses arising from material misstatements or omissions in the disclosure in the offering memorandum.

Intercreditor Agreement

The intercreditor agreement governs the common terms and relationships among the creditors with respect to the Issuer's obligations. The parties to the intercreditor agreement include the main secured creditors of the Issuer. The agreement contains provisions limiting the ability of creditors to vary their respective rights and addresses such issues as voting rights, notifications of defaults and the order of applying proceeds of any debt recovery efforts (including from the sale of collateral). To the extent certain groups of creditors are subordinated to other groups of creditors, the intercreditor agreement sets forth the terms of subordination and other principles to apply. See *Subordination – Lien Subordination*.

Legal Opinions and Disclosure Letters

At closing, both the Issuer's and the initial purchasers' counsels provide the initial purchasers with opinions with respect to certain legal matters and formal disclosure letters (referred to as negative assurance letters or Rule 10b-5 letters). As noted above during our discussion of the due diligence process, the Rule 10b-5 letters indicate that, in connection with counsels'

work on the offering and as a result of their own investigations, nothing causes the counsels to believe that the offering memorandum contains a material misstatement or omission. These letters are the culmination of counsels' comprehensive due diligence of the Issuer during the course of the transaction and satisfaction that the offering memorandum disclosure meets the standards established by the U.S. federal securities law anti-fraud provisions under Section 10b and Rule 10b-5 of the Exchange Act. The Rule 10b-5 letter is typically a requirement for the initial purchasers for any Rule 144A high-yield bond offering.

Comfort Letters

The comfort letter is issued by the Issuer's auditors at pricing and is addressed to the initial purchasers. In the comfort letter, the auditors (i) reaffirm their independence, (ii) state that they stand by their audit opinion on the Issuer's audited financial statements included in the offering memorandum, (iii) describe any procedures they have performed on any interim financial information included in the offering memorandum or on any internal management accounts for the period of time between the date of the Issuer's latest audited or reviewed financial statements and the date of the offering memorandum (referred to as a "**Stub Period**"), (iv) describe any additional agreed-upon procedures they conducted with respect to the Issuer's financial information included in the offering memorandum and (v) provide negative assurance as to the absence of material changes with respect to certain specified financial line items during the Stub Period. The Issuer's auditors will provide a bring-down comfort letter, as of the closing date, to verify that the original comfort letter is still valid.

Post-Launch

To market and build momentum for the offering, the Issuer and the initial purchasers typically conduct a roadshow (the length of which varies from a few days up to two weeks) after launch. During this time, the other members of the working group finalize the bond rating and contractual documentation. Repeat issuers may only conduct an electronic roadshow or conduct the offering on an "overnight" basis without conducting a physical roadshow at all.

Following completion of the roadshow, all parties participate in a bring-down due diligence call with the Issuer's management, the Issuer's auditors deliver the comfort letter, and the Issuer and the initial purchasers hold the pricing meeting during which the offering terms are set. After the pricing meeting, the Issuer, any guarantors and the initial purchasers execute the purchase agreement, at which point the Issuer and the initial purchasers are bound to complete the offering, subject to certain closing conditions. The Issuer's counsel and the initial purchasers' counsel then prepare the final offering memorandum and closing documents in preparation for closing. Upon closing, which usually takes place five business days after the pricing date ("T+5"), the bonds are formally issued and delivered by the Issuer against payment therefore by the initial purchasers.

Mayer Brown is a leading international law firm positioned to represent the world's major corporations, funds and financial institutions in their most important and complex transactions and disputes.

Please visit mayerbrown.com for comprehensive contact information for all our offices.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England & Wales), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) and non-legal service providers, which provide consultancy services (collectively, the "Mayer Brown Practices"). The Mayer Brown Practices are established in various jurisdictions and may be a legal person or a partnership. PK Wong & Nair LLC ("PKWN") is the constituent Singapore law practice of our licensed joint law venture in Singapore, Mayer Brown PK Wong & Nair Pte. Ltd. Details of the individual Mayer Brown Practices and PKWN can be found in the Legal Notices section of our website. "Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2024 Mayer Brown. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.