Baker McKenzie.

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CASH IS KING: HOW CAN ISSUERS MAXIMIZE (OR PRESERVE) LIQUIDITY IN THE SHADOW OF COVID-19

Introduction

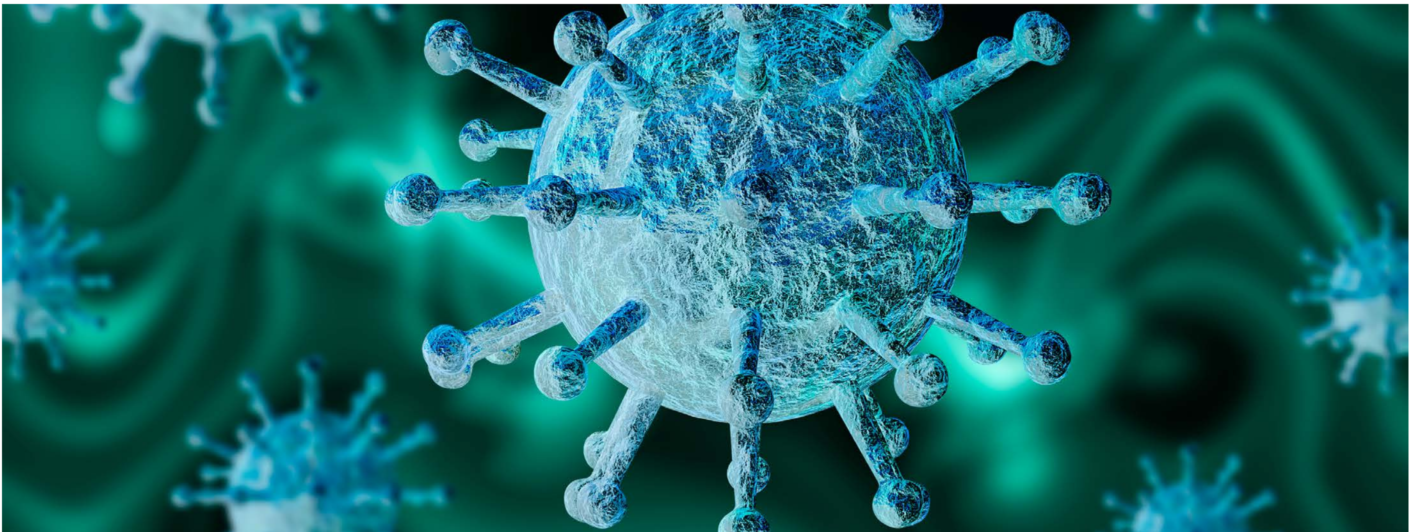
According to the Financial Times since March 1, 2020, more than 130 companies in Europe and the United States have drawn-down at least $124.1 billion from their lenders. Many of our private company clients have also been drawing on their revolving credit facilities ("**RCFs**"), although the true scope of this activity will only become known following March 31 corporate reporting. Given the forecasted reduction in revenue and profits resulting from the government enforced lockdowns, this is prudent liquidity management for companies at all levels of balance sheet strength. For the most part, issuers are drawing-down on their existing RCF capacity which is generally linked to a fixed amount under the permitted "credit facilities basket" in their bond indentures. However, issuers are also looking to raise additional debt above their existing RCF commitments as they assess their liquidity positions for the next 12-18 months. Bank and fund lenders are also looking for opportunities to deploy capital while mainstream event-driven financings are at low levels in line with the reduction in M&A activity as a result of the uncertainty surrounding the economic impact of the COVID-19 pandemic. Accordingly, in this March edition of "In the Know" we look at some potential short- and medium-term levers that issuers can pull to access additional liquidity under a "typical" high yield senior secured notes indenture and consider what options issuers have under their covenants to maximize (or preserve) that debt capacity.

What are the key debt baskets?

Below is a summary of typical permitted debt baskets that could be used to raise additional liquidity. While each of the following baskets offer additional capacity for debt that ranks pari passu with existing senior secured notes, we have focused our review on those aspects of a typical high yield bond covenant package that permit the issuance or borrowing of new debt that is structurally or effectively senior to the existing notes:

1. *Credit facility basket:* first port of call for issuers is the credit facility basket. In addition to the fixed dollar (or euro) amounts, credit facility baskets in senior secured notes indentures typically provide for a grower component that is the greater of the fixed dollar/euro amount and a percentage of total assets, total tangible assets or EBITDA. EBITDA growers in particular have become more prevalent and generally provide for up to 100% of last twelve months ("**LTM**") EBITDA or last two quarters annualized ("**L2QA**") EBITDA. The test date for the grower percentages is generally set off the availability of interim or annual financial statements. However, sponsor deals in particular now have the flexibility to elect, at the option of the issuer, the use of internal financial statements or in some cases management accounts. Given the anticipated declines in EBITDA over the tail end of Q1 2020, issuers will want to access the additional liquidity under the grower portion of this basket before the March 31 quarterly financial statements become available. European senior secured notes structures are often secured on a security package which is shared ("**Common Collateral**") with term loan/RCF and hedging creditors, which is regulated by an intercreditor agreement ("**ICA**").

[1] Eric Platt, Laura Noonan, James Fontanella-Khan, Joe Rennison and Miles Kruppa. "Dash for cash: companies draw $124bn from credit lines." Financial Times. March 25, 2020.



Under these structures, working capital facilities like RCFs will commonly rank ahead of the senior secured notes in right of payment from the proceeds of security enforcement. This is an attractive option for prospective working capital investors who want to sit in a more senior part of the capital structure and also provides a relatively quick execution option for the issuer as, depending on the jurisdictions involved, the new creditor can accede to the ICA to get the benefit of this super senior security without the need to enter into new security documents (or only a simple security confirmation agreement).

2. *General debt basket/local credit facilities basket:* this basket is usually a fixed amount (though it may also include a grower feature), but it is generally not able to be secured on a super senior basis on the Common Collateral via the ICA. Rather, it may be incurred by non-guarantor restricted subsidiaries ("**NGRS**") and, because notes are often issued by holding companies and guaranteed by a limited group of restricted subsidiaries, this debt will generally be incurred by operating/asset owning subsidiaries and thus structurally senior to the holding company issuer (or the guarantor restricted group).

   In order for the general basket debt to be secured, the debt basket must be read together with the 'permitted lien' and the 'permitted collateral lien' definitions in the indenture. The former is the provision which permits securing certain debt baskets on assets which do not form part of the Common Collateral and the later will determine whether it may be secured on the assets that are subject to the Common Collateral. In particular, there are often restrictions on the amount of debt that can be incurred by NGRS, either as an aggregate amount across all debt baskets or under a specified list of permitted debt baskets. A key consideration in utilizing NGRS debt incurrence structures is the availability of enough unencumbered EBITDA/revenue-generating assets (or shares in subsidiaries of companies that do) at the NGRS level to provide credit support to such additional borrowings. While this requires a case-by-case analysis of the issuer's capital structure, we have generally observed a gradual decline in guarantor coverage (expressed as a percentage of group assets, revenue and EBITDA) over time, and security packages are now commonly limited to exclude tangible asset security (i.e. only comprising share pledges, intercompany receivables and bank accounts) which would suggest that a number of credits will be able to utilize this strategy. We would expect this type of financing structure to be more time consuming and expensive for issuers as additional lender due diligence may be required on the new obligor group (which may be domiciled in different jurisdictions from the original credit group thus making diligence more complicated due to the inability to complete site visits or in-person management sessions in the current COVID-19 lockdown environment) and the new debt will not be able to slot into the existing ICA arrangements and will require new security documentation. A new lender may also require an intra-group reorganization to generate a single point of enforcement over the new obligor group, which will usually require more cost and time (and tax analysis). Care will also need to be taken to ensure that the incurrence of such structurally senior debt is not prohibited by one of the most unread covenants in indentures – the restriction on distributions from restricted subsidiaries (or "dividend blocker") covenant or other existing financings. We would expect a well-drafted indenture to provide for the ability to utilize the general basket and local credit facilities baskets for this purpose, but that analysis should be completed with the issuer's legal advisors. We also note that sponsors and issuers have added a number of permitted baskets which effectively operate like general baskets (e.g. additional working capital baskets) that can be utilized on the same basis as the general basket or local credit facilities basket outlined above and may similarly be tapped by NGRS.

3. *Ratio debt:* the ratio debt test is not subject to a dollar or euro cap but permits an unlimited amount of debt to be incurred subject to pro forma compliance with a specified ratio(s). For senior secured notes this usually takes the form of a fixed charge coverage ratio ("**FCCR**") test and an additional consolidated senior secured leverage ratio ("**CSLR**") test for the incurrence of secured debt. Senior secured debt incurred under the CSLR ratio is generally supported by a "permitted collateral lien" enabling the holders of such secured debt to accede to the ICA and providing for such debt to rank pari passu with the existing senior secured notes. However, as with the general basket and local credit facilities baskets discussion above, all or a portion of such ratio debt may be incurred (and consequently secured) by NGRS and may, therefore, be structurally senior to the existing senior secured notes and RCF. A review of the particular indenture is critical but issuers could also combine ratio debt capacity with certain permitted lien capacity (predominately in the form of the general permitted lien basket) to

provide effective super senior security in the form of assets that do not currently secure the existing senior secured notes and RCF. Again, timing is critical for issuers that wish to utilize the ratio test as the test date for the EBITDA numerator (in the case of the FCCR ratio) and denominator (in the case of the CSLR) are typically set off the availability of the most recent financial statements. Issuers will want to access this liquidity before any deterioration of EBITDA is reflected in their next quarterly accounts. Ratio debt can also be used to refresh permitted debt basket capacity or preserve current ratio debt capacity by the use of "designated commitments" or "elected amounts" provisions (see below under *"How to maximize (or preserve) debt capacity: Adjusted EBITDA calculations, reclassification and "designated commitments"* or *"elected amounts" provisions"*). The ratio test allows for quick execution with respect to secured indebtedness ranking pari passu with the existing senior secured notes, but similar time and cost considerations discussed above with respect to the general and local credit facilities baskets apply to the utilization of the ratio debt test by NGRS or the securing of ratio debt over non-collateral by using permitted lien capacity.

4. *Available RP capacity amount:* while this technology is not prevalent throughout the market, top-tier sponsor deals have increasingly been providing for the ability to convert restricted payment ("**RP**") capacity into debt capacity, commonly referred to as an "Available RP Capacity Amount" debt basket. The original thinking behind the inclusion of this basket was that sponsors and issuers were already permitted to carry out a transaction with the same end result by (1) making a dividend to an entity outside of the restricted group using RP capacity, (2) contributing such amounts back into the restricted group as a shareholder loan or equity funding, and (3) using their contribution debt baskets to incur third party indebtedness on 100% (or in some cases 200%) of such contributed amounts. Importantly, while contribution debt baskets are commonly included in high yield bond indentures, the issuer requires cash on balance sheet to make the original dividend. Accordingly, where included, the Available RP Capacity Amount debt basket provides sponsors with additional flexibility as they can complete the RP/debt conversion to increase debt capacity without having cash on hand. The baskets that build the Available RP Capacity Amount vary from deal to deal but it is common to include restricted payment capacity under the "CNI builder basket". The CNI builder basket typically provides the issuer with the ability to make RPs in an aggregate amount equal to 50% of consolidated net income of the issuer from the issue date (provided that if the issuer has posted a loss during this period, then 100% of the loss is deducted in calculating the builder basket). While certain top-tier sponsor deals have removed the requirement to deduct 100% of losses, if CNI builder basket capacity is expected to decline upon availability of Q1 2020 accounts, then issuers should consider whether they would benefit from converting this RP capacity into debt incurrence capacity prior to these accounts becoming available. Finally, issuers will need to consider what security can be provided to secure debt incurred under the Available RP Capacity Amount debt basket and whether such debt may be incurred by NGRS, as this may allow the Available RP Capacity Amount to be incurred as structurally senior debt.

5. *Receivables financing baskets:* most high yield bonds provide for the ability to complete a "Qualified Receivables Financing". These structures are generally required to be incurred at a receivables subsidiary (akin to an unrestricted subsidiary) and can take considerable time and analysis to implement. However, high yield bonds increasingly include more flexibility with respect to recourse receivables and factoring transactions under specified dollar or euro baskets which may provide sponsors with an additional structurally senior liquidity source provided that the receivables in question remain a viable investment for factoring and receivables financing platforms in the current COVID-19 environment.

How to maximize (or preserve) debt capacity: Adjusted EBITDA calculations, reclassification and "designated commitments" or "elected amounts" provisions

As noted above, timing is a key consideration in maximising debt capacity as issuers look to draw down on additional liquidity before ratios and grower baskets start to be impacted by a decline in revenues due to COVID-19, but there are some additional options that issuers can pursue to maximise the debt capacity under the above baskets.

Sponsors and issuers are reviewing their financial definitions to ensure that they are not missing any add-backs to consolidated net income or EBITDA to maximise their debt capacity, including considering whether some of the general "one-time" events which permit add-backs could be used to increase EBITDA and other metrics for COVID-19 related losses. While we are seeing issuers focus on extraordinary events and business interruption insurance proceeds add-backs, our insurance industry experts generally expect that business interruption insurance will not cover losses sustained as a result of the current COVID-19 government-instigated shut down given that most business interruption insurance policies require property damage for coverage to apply.

Another tried and true method to maximise permitted basket capacity is to reclassify previously incurred basket debt under the ratio test to free up additional capacity under permitted debt baskets discussed above. Issuers should review their reclassification provisions with their legal advisors, as it is common to prohibit the reclassification of debt incurred under the credit facility basket but this may only apply to issue date drawings.

A more novel method to provide additional flexibility has been provided in the form of "designated commitments" or "elected amounts" provisions. These provisions typically provide the issuer with the ability to select when it utilizes its ratio or basket capacity (and related liens) even though the debt has not been drawn down under the applicable facility. Once it has been designated, such amount is counted under subsequent ratio tests but it effectively becomes a fixed dollar or eurao amount under the ratio which is available for drawing without need for a subsequent ratio test. This could be beneficial for issuers looking to preserve current ratio capacity in anticipation of an expected worsening in incurrence ratio levels upon availability of Q1 2020 accounts. Again, issuers should review these provisions with their legal advisors to confirm what conditions are applicable to the utilization of this provision, including in particular whether they are required to obtain formal commitments from third party financers and/or whether these provisions are limited to RCFs or can also be utilized for term loans.

Even though I can, should I prime my existing lenders?

Issuers should discuss with their advisors whether it makes sense for them to incur additional priority debt ahead of existing debt held by their existing lender group. While this will depend on the state of the business and urgency for funding, sponsors and issuers would be prudent to first discuss their liquidity needs with their existing lenders and relationship banks to see if additional liquidity can be provided by the existing syndicate. In particular, issuers should consider asking their existing lender group whether they are willing to increase existing facilities on a pari passu basis via an amend and extend with some pricing sweetener or de-risking for the banks in the form of some junior or equity financing. We are generally seeing banks take a constructive approach to their clients' liquidity needs in the current environment and governments (and, in the UK, the Bank of England) have indicated that they expect banks to act appropriately.

Home team assist: sponsor/sponsor affiliates providing additional liquidity

The above summary focuses on obtaining third party external financing but sponsors will be considering whether to inject further funding into their portfolio companies. This could be for a covenant cure under their existing credit facilities (with the proceeds being contributed as equity or subordinated shareholder funding under the senior secured notes covenants). But sponsors and their affiliates could also provide new senior secured or super senior funding directly to their portfolio companies using the debt baskets outlined above. Care should be taken when providing such funding in reviewing any restrictions or conditions under the affiliate transactions covenant in the indenture, and such transactions may require consent under existing credit facilities.

The direct funding approach is advantageous from the sponsor's perspective as it allows the sponsor to hedge its equity exposure by lending directly to the portfolio company and, while lenders would prefer an equity injection by the sponsor, they would generally be more supportive of any new money that sits pari passu alongside their facilities rather than at a super senior or structurally senior level. Sponsors could use this flexibility when negotiating credit extensions with their existing lender group, but when providing any senior or super senior lending to their portfolio companies they should be cognisant of disenfranchisement (as the sponsor/sponsor affiliate will typically not be able to vote under the ICA or the existing facility if provided as an additional facility) and the possibility of equitable subordination issues depending on the jurisdictions involved.

Equitable subordination is a bankruptcy law principle that subordinates claims, including secured claims, of shareholders/connected parties to those of non-shareholders/connected parties. The consequences of equitable subordination can therefore be severe. However, equitable subordination is

jurisdictionally specific and the rules and consequences vary according to the jurisdiction. Finally, in the event that direct funding is not available due to restrictions under the financing documentation, sponsors could use their contribution debt baskets to make an equity or shareholder funding contribution to the issuer and raise external financing on 100% (or in some cases 200%) of the amount of such shareholder funding. While this provision was historically only available to the issuer and the guarantors (and not NGRS) the market has moved to a position whereby contribution debt can be incurred by NGRS or secured on collateral as a permitted collateral lien (with or without CSLR test compliance).

Other options to find liquidity and manage your capital structure?

The above summary is not exhaustive and focuses on short- to medium- term liquidity solutions available to issuers under a "typical" debt covenant. Other options for issuers may include: (1) the sale of non-core assets to generate cash, (2) the use of asset drop down financing structures (where the issuer places certain unencumbered assets into an unrestricted subsidiary using investment capacity under the RP covenant and raises new money debt at such unrestricted subsidiary), (3) extending interest periods under their bank debt and/or seeking waivers or forbearance on upcoming iinterest payments, (4) if their debt is trading at a significant discount, completing debt repurchases to reduce financing costs, (5) receivables discounts, and (6) if appropriate, derivatives-based strategies. The above summary also does not consider more holistic funding solutions that may be required for certain issuers in the form of holdco or junior financings to address near-term maturities (or to refinance a portion of their RCFs) in order to facilitate a "market" financing to obtain additional revolving or delayed draw debt capacity.

Issuers should also continue to follow government announcements with respect to government loan schemes and consider whether they are eligible to participate in these schemes. Focusing on the UK, as at date of this newsletter, it seems that the UK government's COVID Corporate Financing Facility and Coronavirus Business Interruption Loan Scheme will not be available to typical high yield issuers. However, this is a rapidly developing situation which Baker McKenzie is monitoring and further up-to-date analyses and resources relating to COVID-19 can be found at our **Coronavirus Resource Centre** , including regularly updated materials on key government intervention measures being put in place in the UK and across Europe **here**.

A final word about consents

While we have focused on senior secured notes indentures, sponsors and issuers should review their existing shareholders' agreements, RCFs, ICAs and other facilities to confirm whether there are any prohibitions under those documents that might restrict the additional financings noted above, particularly where the issuer is looking to incur more super senior debt. There may also be issuers that are in a position to obtain additional super senior debt from either their existing banking syndicate or new potential lenders but are (notwithstanding the above optionality) currently constrained from doing so under their indenture(s). We would expect that, under a typical indenture, issuers should be able to upsize their super senior RCF basket (and related lien) with 50.1% consent of noteholders, but care should be taken when reviewing the amendment provisions of the indenture as holders may seek to challenge such an amendment if there is a 90% (or 100%) consent threshold to amend or modify provisions of the indenture that affect the ranking of the notes.

Conclusion

Sponsors and issuers should, in consultation with their advisors, consider the various options available to them under their indenture covenants and other financing documentation and the related issues canvassed in this update when discussing additional funding options with their existing bank syndicate and potential lenders. Careful consideration of their covenant packages is required to ensure that sponsors and issuers apprise themselves of all the flexibility available to them to get through any anticipated liquidity crunch.

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