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Covenants 101: Decoding Bond and Loan Covenants

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May 7, 2025

Bonds vs. Loans

Both Indentures and Credit Agreements are contracts under which a company borrows money

- **Key differences between bonds and loans:**
  - Bonds are securities
  - Transferability
  - Pro rata treatment
  - Call protection
  - Fixed rate vs. floating rate

What are covenants?

Covenants are agreements by the company to do or not certain things

- **No fiduciary duties owed to creditors**
- **Creditors must bargain for protections**
- **Key covenant protections include restrictions on:**
  - Incurring additional debt
  - Incurring liens securing debt
  - Making Restricted Payments (shareholder payments, investments, prepayments to junior creditors)
  - Change of Control
  - Asset Sales

Debt Covenant

- **Purpose:** Limit future debt incurrence to increase chances that the company will be able to repay the debt

- **Basics:** Restrict incurrence of debt (including disqualified or preferred stock) unless there is a specific permission to do so (a “basket” or a “carveout”).
  – A ratio test
  – A dollar-capped/grower basket

- **Two kinds of ratio tests:**
  – Coverage Ratio - (e.g., EBITDA: interest expense)
  – Leverage Ratio - (e.g., debt: EBITDA)

- EBITDA and covenant EBITDA are different!

Liens Covenant

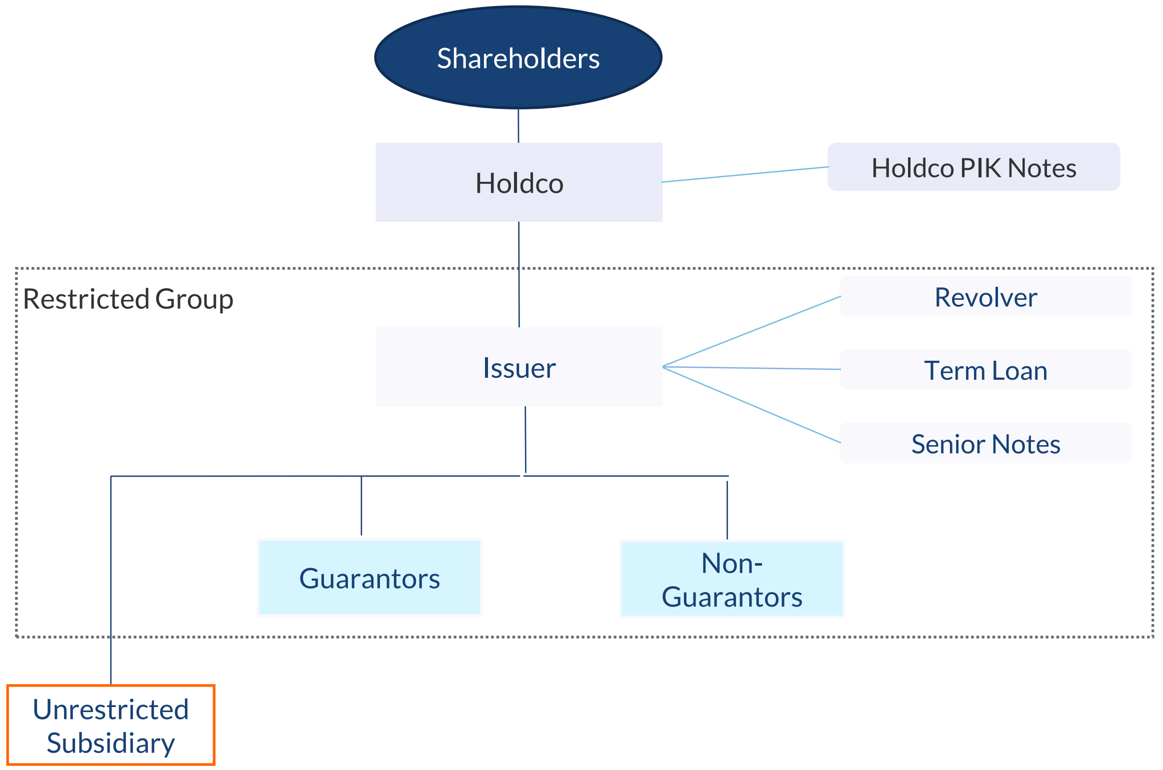
- **Purpose:** Protect seniority position / limit collateral dilution
  - Limit amount of debt that may be effectively senior to an unsecured bonds
  - Limit the amount of new debt that would dilute the collateral for a secured loan or bond

- **Basics:** Two types of Liens covenants:
  - **Negative pledge**
    - Prohibits liens unless the bonds are equally and ratably secured, but also allows liens to be incurred under carveouts called "Permitted Liens."
  - **True liens**
    - Prohibits all liens except Permitted Liens.

Restricted Payments Covenant

- **Purpose:** Restrict undesirable transactions such as:
  - Dividends
  - Stock Repurchases
  - Retiring some types of junior debt ahead of the bonds
  - Investments in entities that are not Restricted Subsidiaries

Restricted Payments Covenant: Keeping Value in "The Box"



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Change of Control

- **Purpose:** Protecting creditors when company ownership changes
- **Bonds:** Put right at 101% of par if a “Change of Control” occurs
- **Loans:** Usually an EoD requiring repayment in full (typically at par)
- **Change of Control usually includes:**
  - Change in majority voting control
    - But: “Permitted Holders” do not trigger a Change of Control
  - Sale of “substantially all” assets
  - Merger of two public companies (sometimes)
  - Continuing directors
  - Liquidation / dissolution
- There is sometimes (but not usually) a ratings condition
- There is sometimes (but not usually) a leverage-based portability exception

Asset Sales

- **Purpose:** Maintain assets within the restricted group or reduce debt in recognition of diminished asset base

- **Basics:** Typically permitted subject to FMV and 75% cash consideration requirements

- **Bonds:** Par offer
- **Loans:** Mandatory prepayment

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