

High yield bonds: know your numbers

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Authors: [Jill Concannon](#), [Gilles Teerlinck](#), [Anna Soroka](#), [Claudia Hasbun](#)

The coronavirus pandemic has had an unprecedented impact on many businesses, including those with outstanding high yield bonds. The incurrence covenant regime (and absence of any maintenance covenants) means that, provided liquidity is sufficient to make interest payments, high yield issuers may be able to push through the period. However, issuers (and bondholders) should be mindful of the key numbers to consider when a high yield default is on the horizon, to ensure they are organized for any default scenario.

In the European high yield bond market, the activities of the issuer and its restricted subsidiaries (the “group”) are governed by the covenants under the high yield indenture. Customary Events of Defaults (“EoDs”) include, among others, bankruptcy of the group, not paying principal or interest on the notes when due, breach of covenants, payment default under, or acceleration of, other indebtedness, impairment of security or a judgment for the payment of money against the group.

Event of Default? Not so fast

First, the covenants in high yield indentures are incurrence-based covenants —*i.e.*, they do not need to be tested on a regular basis and do not have to be “maintained.” Compliance with most of the covenants is tested only when the group proactively takes an action, such as borrowing more money, paying a dividend or selling assets. For example, if the group’s net secured leverage ratio, which tests net secured debt to EBITDA, exceeds the applicable threshold because EBITDA is declining and not because the group incurred new secured debt or distributed dividends, it will limit the ability of the group to incur more secured debt or pay dividends but it will not constitute an EoD.

Second, certain EoDs specify a minimum threshold amount for the EoDs to apply and others have grace periods that allow the group an amount of time to cure the default before the default becomes an EoD. While there is no grace, or cure, period for principal payment defaults (and often for any failure to comply with the merger covenant or a requirement for a change of control offer), the grace period for non-payment of interest is usually **30 days**. Other EoDs, such as compliance with other covenants, failure to pay judgments or impairment of security usually allow for **30-60 days’** grace period and require a notification of the default to the group in order to constitute an EoD. In addition, there is the cross-payment default/acceleration under other debt instruments provision, which is triggered only upon payment default of the principal at maturity (at the expiration of all grace periods) or by the actual acceleration of indebtedness by the other creditors and not only the right to accelerate. To result in an EoD under the notes, the other debt has to become due and payable.

Not a job for one

Only the trustee or a group of bondholders (typically representing more than 25 per cent. of the outstanding bonds, sometimes 30 per cent.), rather than an individual bondholder, may declare an EoD and accelerate the payment of the notes.

For most defaults, such as for a covenant breach, or a judgment default or payment default under, or acceleration of, another debt instrument, the trustee or such group of bondholders must provide a written notice to the issuer declaring that a default has occurred, and allowing the relevant grace period to cure or remedy the default. If the issuer takes no actions to, or cannot, cure the default during the grace period, then an EoD is deemed to have occurred. Even once an EoD is deemed to have occurred, in order for the notes to become immediately due and payable, the trustee, or such group of bondholders, must actively declare the acceleration of the payment of the notes. The main exception to this principle is that, upon a bankruptcy event of default, the notes become due and payable immediately, without the need of any other actions by the trustee or the bondholders.

It is important to note, that although the trustee has the authority to take independent actions under the high yield indenture, in practice the trustee will declare a default, EoD or accelerate the payment of the notes only upon instructions from the bondholders, typically subject to receiving a satisfactory indemnification. In addition, it should be noted that an exception often exists to provide that the right of any holder to receive payment when due of principal or to bring suit for the enforcement of any such payment is often included. This sacred right may provide additional rights though may also require some procedural steps in practice to enforce.

Majority rules! (or, the downside of democracy)

In a distressed situation, the group may seek amendments to or waivers of the covenants, which it would do so through a consent solicitation.

Most European high yield indentures specify that an affirmative vote of more than **50 per cent.** of the outstanding notes is sufficient to amend the high yield indenture or waive an EoD (other than failure to pay interest of principal when due, which can typically be waived with the consent of more than **90 per cent.** of holders) to bind all bondholders, including bondholders who did not attend and vote, or who voted in a manner contrary to the relevant majority. Generally, the amendments may eliminate restrictive covenants, including the limitation on incurrence of indebtedness or payment of dividends. The >50 per cent. threshold makes it easier for the group to push through various amendments (including amending the debt covenant) and allow the group to incur additional debt that would otherwise be restricted by the covenants.

To change the “money terms”—e.g., principal, interest rate, currency, release of security and maturity—the group will need the consent of at least 90 per cent. of the bondholders (somewhat similar to the Trust Indenture Act requirement of 100 per cent. but with some headroom to provide flexibility in transactions not subject to such act). One notable exception are Italian high yield indentures, which typically require the consent of only 75 per cent. of the bondholders to change the “money terms.” Also, in certain European high yield indentures there is 75 per cent. threshold to release all or substantially all security. In contrast, amendments that are harmless to bondholders, such as clarifying ambiguities, adding covenants on the part of the issuer or adding guarantees, can be made without the consent of any bondholders.

Zero to 120

The reporting covenant will often require the issuer to provide the bondholders with current information on the group’s financial performance. This covenant generally requires the group to provide full public disclosure for as long as the notes are outstanding, whether or not the group is subject to U.S. Securities and Exchange Commission (the “SEC”) or other reporting requirements. The covenant also specifies the amount of time an issuer has to provide its financial reports, which typically is set at **60 days** after the end of a quarterly period and **120 days** after the end of an annual period, with sometimes a longer period for the first quarterly report and the first annual report. The reporting covenant also requires the group to report any material event promptly after the occurrence of such event. The covenant does not include a provision for additional time for reporting such information and delay in such reporting may constitute breach of covenants under the European high yield indenture and, if not cured, a potential EoD.

Although the SEC and other exchanges have delayed reporting timeframes for some companies, in the typical European high yield indenture there is a hard deadline for reporting. As mentioned above, the reporting covenant does not include carve-outs that would allow for a delay in reporting and there have been a number of consent solicitations of bond issuers recently to extend the reporting deadline. Regardless of any conditional reporting relief that the SEC or other exchanges may provide, high yield issuers whose notes are governed by the typical European high yield indenture will still be required to report on time.

For further information on the impact of the coronavirus on businesses, please see our [Coronavirus Resource Centre](#).

EMEA leveraged finance partners

Jill Concannon ●

Partner, London
T +44 20 7532 1534
E jconcannon@whitecase.com

Christopher Czarnocki ■

Partner, London
T +44 20 7532 1201
E cczarnocki@whitecase.com

Jeremy Duffy ■

Partner, London
T +44 20 7532 1237
E jduffy@whitecase.com

Gareth Eagles ■●

Partner, London
T +44 20 7532 1251
E geagles@whitecase.com

Jacqueline Evans ■

Partner, London
T +44 20 7532 1404
E jevans@whitecase.com

Martin Forbes ■

Partner, London
T +44 20 7532 1229
E mforbes@whitecase.com

Emma Foster ■

Partner, London
T +44 20 7532 1299
E efoster@whitecase.com

James Greene ■●

Partner, London
T +44 20 7532 1439
E jgreene@whitecase.com

James Hardy ■

Partner, London
T +44 20 7532 2728
E james.hardy@whitecase.com

Colin Harley ■

Partner, London
T +44 20 7532 1200
E colin.harley@whitecase.com

Monica M. Holden ●

Partner, London
T +44 20 7532 1483
E mholden@whitecase.com

Richard Lloyd ■

Partner, London
T +44 20 7532 1247
E rlloyd@whitecase.com

Shane McDonald ■

Partner, London
T +44 20 7532 2698
E shane.mcdonald@whitecase.com

Jeffrey Rubinoff ■

Partner, London
T +44 20 7532 2514
E jeffrey.rubinoff@whitecase.com

Shameer Shah ■

Partner, London
T +44 20 7532 1215
E shameer.shah@whitecase.com

Gilles Teerlinck ■●

Partner, London
T +44 20 7532 2232
E gilles.teerlinck@whitecase.com

Justin Wagstaff ●

Partner, New York
T +1 212 819 2694
E jwagstaff@whitecase.com

Fergus Wheeler

Partner, London
T +44 20 7532 2288
E fergus.wheeler@whitecase.com

Ben Wilkinson ■

Partner, London
T +44 20 7532 1276
E bwilkinson@whitecase.com

Thierry Bosly

Partner, Brussels
T +32 2 239 25 09
E tbosly@whitecase.com

Hadrien Servais ●

Local Partner, Brussels
T +32 2 239 2544
E hadrien.servais@whitecase.com

Claire Matheson Kirton ■

Partner, Dubai
T +971 4 381 6218
E cmathesonkirton@whitecase.com

Rebecca Emory ●

Partner, Frankfurt
T +49 69 29994 1432
E rebecca.emory@whitecase.com

Dr Thomas Flatten

Partner, Frankfurt
T +49 69 29994 1233
E tflatten@whitecase.com

Florian Degenhardt

Partner, Hamburg
T +49 40 35005 364
E fdegenhardt@whitecase.com

Vanessa Schuermann ■

Partner, Frankfurt
T +49 69 29994 1431
E vanessa.schuermann@whitecase.com

Gernot W. Wagner ●

Partner, Frankfurt
T +49 69 29994 1430
E gernot.wagner@whitecase.com

Florian Ziegler

Partner, Frankfurt
T +49 69 29994 1575
E florian.ziegler@whitecase.com

Tanja Törnkvist

Partner, Helsinki
T +358 9 228 64 351
E ttornkvist@whitecase.com

Güniz Gökçe

Association Partner, Istanbul
T +90 212 355 1311
E guniz.gokce@gkcpartners.com

Fernando Navarro ■

Partner, Madrid
T +34 91 787 6373
E fnavarro@whitecase.com

Yoko Takagi

Partner, Madrid
T +34 91 787 6320
E ytakagi@whitecase.com

Iacopo Canino

Partner, Milan
T +39 020 068 8340
E iacopo.canino@whitecase.com

Gianluca Fanti

Partner, Milan
T +39 02 00688 390
E gianluca.fanti@whitecase.com

Michael Immordino ●

Partner, London
T +44 20 7532 1399
E michael.immordino@whitecase.com

Alessandro Nolet ■

Partner, Milan
T +39 020 068 8420
E alessandro.nolet@whitecase.com

Andrea Novarese

Partner, Milan
T +39 02 00688 440
E andrea.novarese@whitecase.com

Natalia Nikitina

Partner, Moscow
T +7 495 787 3027
E nnikitina@whitecase.com

Samir Berlat

Partner, Paris
T +33 1 55 04 15 51
E sberlat@whitecase.com

Denise Diallo ●

Partner, Paris
T +33 1 55 04 15 18
E ddiallo@whitecase.com

Tomáš Jíně ■

Partner, Prague
T +420 255 771 233
E tjine@whitecase.com

Jan Linda

Partner, Prague
T +420 255 771 271
E jlinda@whitecase.com

David Plch

Partner, Prague
T +420 255 771 298
E dplch@whitecase.com

Jonathan Weinberg ■

Partner, Prague
T +420 255 771 262
E jweinberg@whitecase.com

Oscar Liljeson

Partner, Stockholm
T +46 8 506 32 379
E oscar.liljeson@whitecase.com

Carl Hugo Parment

Partner, Stockholm
T +46 8 506 32 341
E carlhugo.parmen@whitecase.com

Magnus Wennerhorn

Partner, Stockholm
T +46 8 506 32 370
E magnus.wennerhorn@whitecase.com

Nicholas Coddington ■

Local Partner, Warsaw
T +48 22 50 50 160
E ncoddington@whitecase.com

Tomasz Ostrowski ■

Partner, Warsaw
T +48 22 50 50 123
E tostrowski@whitecase.com

■ English Qualified ● US Qualified

White & Case LLP
5 Old Broad Street
London EC2N 1DW
United Kingdom

T +44 20 7532 1000

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