Testing Times: Insights into the Timing of Incurrence Covenant Testing

European Leveraged Finance Alert Series: Issue 3, 2019

March 2019

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Investors in high yield debt expect protections to be included in documentation in order to prevent bond issuers from taking certain actions that deteriorate credit quality. To this end, issuers agree to a series of undertakings, or covenants, that restrict their ability to do certain things. Under these restrictions, known as "incurrence covenants", the issuer is prevented from taking a specified action unless it meets a specified test (or is permitted to do so under an exception to that test). As a general rule, the action in question is tested as at the date of its closing (*i.e.*, the date of incurrence) and on a *pro forma* basis taking into account its immediate effect. However, in recent years, issuers have been acquiring increasing flexibility under high yield documentation to test for compliance prior to the actual date of incurrence. In this article we will examine some of these provisions and analyse how they work as well as how they can prove useful to issuers.

What is an incurrence covenant and when does testing normally occur?

An incurrence covenant provides that an issuer may take a specified action (such as incurring debt, paying dividends, repurchasing its shares or making certain investments) only if, upon completing the action and *pro forma* for its occurrence, the issuer meets the test prescribed by that covenant. For example, an incurrence covenant may stipulate that an issuer can incur additional debt only if it meets a specified leverage ratio, as calculated immediately upon such incurrence and on a *pro forma* basis taking into account the application of the related proceeds. Typically, the leverage ratio requirement would be tested as at the time that the action actually occurs (*e.g.*, on the date of incurrence of the relevant debt). However, high yield documentation increasingly allows issuers to opt to test for compliance not as at the date of completion of the action that triggers the testing requirement under the covenant but as at a date prior to completion (though nonetheless *pro forma* for the impact of the action). If the proposed action satisfies the covenant test as at the earlier testing date, then the covenant would be deemed to be satisfied as at the date of the closing, even if the action would not pass muster if tested on that later date.

Why might an issuer need testing time flexibility?

Allowing issuers to test compliance of a specified action ahead of the date of actual completion of that action means that they can opt to test for compliance on a date on which they have certainty that the test would be met. This certainty is useful in particular where a long time elapses between the signing of documentation governing a transaction and its closing.

This is the case where, for example, an issuer seeking to acquire a target signs a stock purchase agreement (or SPA) but (not unusually) the closing of the acquisition is subject to securing competition authority approval. Suppose the issuer intends to finance the acquisition with new debt the incurrence of which requires testing under a leverage or coverage ratio. The issuer would be certain that on the date of signing the SPA (assuming the acquisition closed on that day) the proposed new debt would meet the ratio test. However, given the amount of time required to obtain competition authority clearance and the potential for a decline in EBITDA (not only the issuer's but also the target's) over that period, the issuer could not be certain on the date of the signing that the new debt would be compliant as at the date of the closing when it is actually incurred. Thus the standard approach of requiring compliance testing as at the date of incurrence/closing may pose significant difficulties for an issuer seeking to incur debt to finance an acquisition where the compliance of that debt depends on future *pro forma* EBITDA performance.

A similar concern may arise where an issuer enters into a revolving credit facility. The issuer may have been permitted under its existing bond indenture to incur the full amount of debt committed under the revolver on the date it was entered into. However, a subsequent decline in EBITDA may result in the issuer not being able to draw some or all of the commitment at a future date due to non-compliance with a ratio test. To address these and similar concerns, and as discussed below, high yield documentation has in recent years provided increasing flexibility to issuers to allow them to test for covenant compliance prior to the date of actual closing of the action that triggers the testing requirement.

What kinds of provisions allow issuers to conduct pre-incurrence testing?

The ability of an issuer to rely on pre-incurrence testing for incurrence covenants has become widely accepted in certain covenants. The three provisions discussed below, among others, are increasingly common in high yield bond indentures and have even become relatively standard in the past few years.

Limited Condition Acquisition / Transaction

The term "limited condition acquisition" refers to any acquisition, including by way of merger, the consummation of which is not conditioned on obtaining third-party financing. The limited condition acquisition provision enables an issuer that has committed to making an acquisition without a "financing out" to select the date on which the SPA is entered into, rather than the date of the closing of the acquisition, as the testing date for purposes of determining compliance under a ratio or basket. As a result, the level of the ratio or availability under a basket is calculated *pro forma* for the relevant incurrence of debt and the application of the resulting proceeds as though they had occurred on the date of the SPA, rather than the date of the closing (which at the time of signing of the SPA may not even be known). Assuming the issuer meets the test on the SPA date, the issuer would have certainty that it would not be blocked from incurring the relevant debt and closing the acquisition due to a decrease in EBITDA occurring after the date of the SPA. However, if compliance testing is required for any other transactions set to occur between the SPA date and the date of closing of the acquisition, then the impact of the acquisition (and the related debt incurrence) will be taken into account in calculations related to such additional compliance testing.

Historically, the flexibility to test ratios and baskets as at the date of the SPA rather than the closing date was limited to so-called limited condition acquisitions. Since such acquisitions do not have a financing out, they are considered to be more likely to close, which means that the flexibility to test pre-incurrence is seen by investors as no more than a limited accommodation. However, more recently, this flexibility has been expanded to permit pre-incurrence testing with respect to other types of issuer actions and transactions, such as irrevocable repayments or announced distributions (including dividends) – without the requirement that they not be conditioned on obtaining third-party financing.

Reserved Indebtedness

Another common type of pre-incurrence testing mechanism included in high yield documentation is the so-called "reserved indebtedness" provision. Under this provision, an issuer entering into a revolving credit facility or other commitment to incur debt can opt to designate the date of its entry into the facility or commitment (rather than the date of the drawing thereunder) as the testing date for determining compliance with a ratio or basket and to test the full amount of the commitment as at that prior date. If the committed amount complies with the test as at the date of entry into the revolver or other facility, then it will be deemed to comply on any future date on which it is drawn. In effect, the full amount of the commitment would be "grandfathered", and the issuer could draw any amount under it without any requirement for further testing. However, the grandfathered commitment, which is designated as "reserved indebtedness", would be deemed to be outstanding for the purpose of compliance testing for any other debt to be incurred under the debt covenant.

Grandfathering Growers

An increasingly common enhancement to the so-called growers that feature in certain permitted debt baskets is the grandfathering provision with respect to refinancings. Permitted debt baskets that have EBITDA-based growers allow the issuer to incur debt up to a maximum amount not exceeding a fixed monetary limit or a specified percentage of LTM EBITDA at the time of incurrence, whichever is greater. If, at the time the issuer seeks to make use of the basket, the percentage of LTM EBITDA is greater than the fixed monetary limit, then the issuer could incur the greater amount of debt allowed by the grower. However, if at a later date the LTM EBITDA is lower than it was at the time of the original incurrence, then that same basket would not then have enough room to accommodate all the debt needed to refinance the original debt. In consequence, the issuer could not make use of the same basket for a full refinancing at that date.

To remedy this, high yield documentation increasingly provides for a grandfathering mechanism: if an issuer incurs debt to refinance debt that was previously incurred in reliance on an EBITDA-based grower, that refinancing debt would be deemed to be permitted up to the amount of the original debt plus fees, costs and premia. This would be so even if, due to EBITDA underperformance after the original debt is incurred, the amount of refinancing debt exceeds the specified percentage of LTM EBITDA under the relevant basket on the refinancing date. In effect, the testing date for debt incurred in reliance on an EBITDA-based grower in a permitted debt basket remains the same for any debt incurred under that same basket which is used to refinance the initial debt.

Note that this flexibility would not allow the issuer to incur additional debt in reliance on a basket whose capacity is already filled (or exceeded) by other debt or refinancing debt with respect to it. However, if capacity under an EBITDA-based grower limit were subsequently to increase (beyond the level necessary to accommodate the refinancing debt) due to an increase in EBITDA, there would be room for the additional debt.

Conclusion

Incurrence covenants in high yield indentures can present timing issues for issuers that wish to undertake certain activities, and can thereby restrict their opportunity to take certain actions in the future, even if those actions were permitted at the time definitive documentation governing them was entered into. In response to this problem, pre-incurrence testing provisions have become common in bond indentures, allowing issuers to have greater certainty when contemplating future actions that trigger covenant testing. It is important for both issuers and investors in high yield bonds to be aware of the variety of pre-incurrence testing provisions and the scope of the flexibility they afford.

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