

Thinking outside the box: the basics of Unrestricted Subsidiaries

European Leveraged Finance Alert Series: Issue 5

May 2017

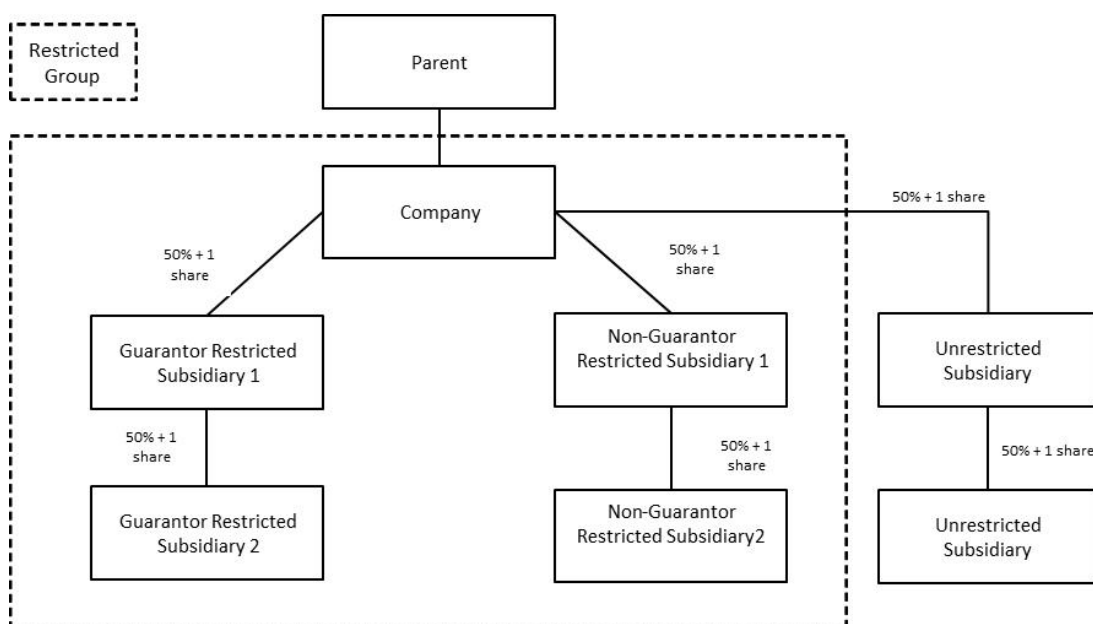
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We are often asked by clients whether an “Unrestricted Subsidiary” can be used to complete a transaction which may not otherwise be permitted by their high-yield notes indenture or loan agreement with high-yield style incurrence covenants. In this alert, we set out some key factors to bear in mind when considering the use of an “Unrestricted Subsidiary”, and some of the pitfalls which are often not considered when structuring transactions in this way.

What is an “Unrestricted Subsidiary”?

A typical covenant package will limit a corporate group from taking certain actions by applying restrictions to a designated entity (herein referred to as the “Company”) and its “Restricted Subsidiaries”. This can be defined as the “Restricted Group”. By default, all subsidiaries of the Company will be part of the Restricted Group unless they are specifically designated as “unrestricted”. Any parent entities of the Company are usually not in the Restricted Group.

This is illustrated in the diagram below:



A Restricted Subsidiary is any subsidiary that is not an “Unrestricted Subsidiary”. It is important to note the following:

- a Restricted Subsidiary must be a “subsidiary”, which is typically an entity in which the Company has, directly or indirectly, the power to vote more than 50% of the shares which elect directors of the Company. Therefore, entities in which the Company owns a minority stake (or exactly 50%) will not be Restricted Subsidiaries. In contrast, an entity in which the Company only owns 50% plus one share will automatically be part of the Restricted Group unless it is specifically designated as an “Unrestricted Subsidiary”;
- once an entity is designated as an Unrestricted Subsidiary (see below), each of that entity’s subsidiaries will become an Unrestricted Subsidiary. Prior to such designation, the number of layers in the group is irrelevant. In the chart above, Guarantor Restricted Subsidiary 1, Guarantor Restricted Subsidiary 2, Non-Guarantor Restricted Subsidiary 1 and Non-Guarantor Restricted Subsidiary 2 are in the Restricted Group, notwithstanding the additional layers of corporate entities. This goes on ad infinitum in the corporate structure;
- the covenants contained in the relevant financing document will apply to all members of the Restricted Group. There are differences over what a Guarantor Restricted Subsidiary is able to do in comparison to a non-Guarantor Restricted Subsidiary, but the main point to note is that all entities which are part of the Restricted Group are subject to the covenants and are Restricted Subsidiaries. It is only following designation as an Unrestricted Subsidiary that a subsidiary is not subject to the covenants; and
- unrestricted Subsidiaries for the purposes of covenants will be treated as if they are unaffiliated third parties, and the covenants will limit any transaction that can take place among the Restricted Group, on the one hand, and the Unrestricted Subsidiaries, on the other. Moreover, transactions of the Restricted Group with Unrestricted Subsidiaries, unlike transactions with an unrelated third party, will be subject to additional scrutiny under the “Transactions with Affiliates” covenant.

Designation – what needs to happen and what are the advantages?

Requirements

A Restricted Subsidiary is any subsidiary that is not an “Unrestricted Subsidiary”. It is important to note the following:

- the designation of any subsidiary as an Unrestricted Subsidiary and any asset contribution of the Restricted Group to such subsidiary will be considered an “Investment”. The “Restricted Payments” covenant prohibits investments, and in order for the Company to be able to designate the subsidiary and contribute any assets, it must have “Restricted Payment” or Permitted Investment capacity in an amount equal to the fair market value (at the time of such designation or contribution, typically as determined in good faith by the board of directors) of any asset contributed and the value of the Company’s equity interest in a Restricted Subsidiary. The Company is permitted to aggregate multiple baskets to make an investment;
- it is often not possible to designate a principal subsidiary as an Unrestricted Subsidiary;
- the remaining members of the Restricted Group cannot be liable for any debt of the Unrestricted Subsidiary or any of its subsidiaries; and
- the Restricted Group cannot be liable for any further investments, equity subscriptions or contributions or requirements to protect the financial condition of the Unrestricted Subsidiary.

If the above are fulfilled, the designation of an Unrestricted Subsidiary is typically quite straightforward via the delivery of certificates to the relevant Trustee or Agent.

Advantages

Following a designation of an Unrestricted Subsidiary, the designated entity and its subsidiaries are no longer subject to the covenants in the finance documents. This means they can take the following actions, among others, without restriction under the finance documents:

- incur debt;
- grant security;

- sell assets;
- pay dividends;
- undertake affiliate transactions;
- distribute shares in Unrestricted Subsidiaries to shareholders; or
- make investments.

This offers a borrower/issuer significant flexibility with respect to financing or operating such entity. However, there are both documentary and practical implications to consider, as discussed below.

Considerations and limitations with respect to an Unrestricted Subsidiary

The covenant relaxation/release with respect to an Unrestricted Subsidiary sounds extremely appealing to borrowers/issuers. However, it is not so simple, as the following key limitations must be considered:

Capacity to designate

By default, all subsidiaries of the Company will be part of the Restricted Group, unless they are specifically designated as unrestricted. As described above, the designation of an Unrestricted Subsidiary and any asset contribution to such subsidiary is an “Investment”. The Company must have “Restricted Payment” or Permitted Investment capacity in an amount equal to the fair market value of the assets contributed and the value of the Company’s equity interest in a Restricted Subsidiary to be able to designate a subsidiary as an Unrestricted Subsidiary.

The capacity for the Investment may be established under various baskets, including the “build-up” basket (which may be subject to compliance with further requirements such as the debt ratio and no event of default), the Restricted Payment General basket and Permitted Investment baskets (which may include, among others, a general basket and a specific Unrestricted Subsidiary basket).

For a large asset/business segment, the requirement for making such Investment may be challenging to meet, or may use up a substantial amount of Restricted Payment capacity which the Company may have intended for other purposes such as a return to shareholders.

Effect on ratios

Incurrence, and where applicable, maintenance, ratios are affected by the performance of the Restricted Group and its assets, both with respect to EBITDA on the one side of the ratio and the financial metric on the other side of the ratio (interest cover/leverage etc.). Thus, the Restricted Group “loses” the benefit of the Unrestricted Subsidiary for the purpose of the calculation of various grower baskets and the ratio, though it also excludes its obligations from the financial test.

To the extent the Unrestricted Subsidiary pays a dividend to the Restricted Group, this is typically included in EBITDA, but this is a cash based increase, rather than on a consolidated basis, which affects the ratios of the Restricted Group.

Reports

The designation of a subsidiary as an Unrestricted Subsidiary, in certain circumstances, will require the Group to prepare separate quarterly and annual financial reports for the Restricted Group excluding the Unrestricted Subsidiaries.

Increase in Restricted Payments capacity

As mentioned above, it is possible to make investments in Unrestricted Subsidiaries using one of the exemptions, including the build-up basket. This basket is refillable and builds up over time as money comes into the Restricted Group. Typically, the size of the basket is calculated by adding up 50% of the consolidated net income (accumulated during a defined period), 100% of certain capital contributions and the return to the Group, including payments received from Unrestricted Subsidiaries. Thus, payments received from Unrestricted Subsidiary may increase the build-up basket and subsequently the capacity of the Restricted Group to make Restricted Payments.

“Third party” nature of Unrestricted Subsidiaries

While Unrestricted Subsidiaries are exempt from the application of the covenants, there are several advantages to being in the Restricted Group, which are often overlooked. This includes unlimited transfers of assets, intra-group loans and capital contributions/investments as well as all actions permitted under the Affiliate Transactions and other relevant covenants. Once an entity is an Unrestricted Subsidiary, such flexibility is taken away. Depending on the corporate structure of a Company and its subsidiaries and the asset the Unrestricted Subsidiary purchases or receives as a capital contribution as part of the investment, this may be problematic, given shared costs and expenses with the Restricted Group and other operational cross-overs. Companies must consider their ongoing relationship with the Unrestricted Subsidiary and whether this can feasibly be kept on an arm's length basis.

Reversal – bringing an Unrestricted Subsidiary back into the Restricted Group

The designation of a subsidiary as an Unrestricted Subsidiary is reversible, and the entity can be brought back into the Restricted Group. This releases any Restricted Payment capacity used in designating the relevant Unrestricted Subsidiary. The main limitation however is that the Restricted Group needs to be able to incur any debt owned by the Unrestricted Subsidiary under the Restricted Group debt covenant. Given one of the reasons for the designation of an Unrestricted Subsidiary is potentially to raise debt, it is entirely possible that the debt quantum raised will be too great to bring the Unrestricted Subsidiary back into the Restricted Group, or will use up a significant amount of debt incurrence capacity.

Unrestricted Subsidiaries in practice

As discussed above, designating an Unrestricted Subsidiary creates operational flexibility for the Unrestricted Subsidiary but also generates various factors which must be considered in relation to the ongoing operations of the Restricted Group.

One particularly effective use of Unrestricted Subsidiaries is where a group is looking to finance a particular business unit and that particular business unit can incur more debt on a standalone basis than would be available under the Restricted Group's debt incurrence covenant. For example, Unrestricted Subsidiaries may be useful for project finance or whole-of-business securitization structures for individual business units as these financing structures would typically require security and guarantee arrangements and dividend limitations at the business unit level that may not be permitted under the Restricted Group's financing. Further, joint venture investments (where the Company is the majority stakeholder), and the financing of such investments, may be easier to structure through an Unrestricted Subsidiary as the joint venture partner may not want to be subject to the limitations of the Restricted Group's financing, and any joint venture financing would again likely have its own security and guarantee arrangements and dividend limitations at the joint venture level. We note again, for the reasons stated above, that these financing structures are only operationally feasible if the relevant business unit can be operated on a ring-fenced basis.

There have also been some more recent transactions, for instance iHeart Communications and J.Crew Group Inc., where Unrestricted Subsidiaries have been used as a restructuring tool. In these transactions, the Restricted Group transferred a valuable asset from the Restricted Group into an Unrestricted Subsidiary and the Unrestricted Subsidiary was then able to use the assets for purposes free from the reach of the restrictive value-protecting covenants, including raising cash to repay or exchange debt that the Restricted Group would otherwise have been restricted from repaying. The iHeart Communications transaction was challenged in court as investors viewed this as effectively avoiding the finance document covenants; however the court found in the company's favor, ruling that it had not violated its finance documents as the relevant investment of the asset in an Unrestricted Subsidiary was permitted and the transaction undertaken was not otherwise prohibited.

Conclusion

In conclusion, given the right assets and corporate group structure, the creation of an Unrestricted Subsidiary can be a useful regime for a Company to gain certain operational and financing flexibility. However, this needs to be balanced against the requirements to exclude the performance of the Unrestricted Subsidiary from consolidated financial tests and to treat the Unrestricted Subsidiary essentially as a third party which may impose its own counterbalancing restrictions on the Restricted Group's operations.

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