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European High Yield Bond Reporting Covenants: Who Needs to Know and Why?

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Most high yield issuers are required by the terms of their indentures to report financial and business information to investors. Issuers provide this information so that investors can continually evaluate their investment. The information European issuers provide varies and is primarily dictated by market practice. Nevertheless, U.S. securities laws are the basis from which market practice in Europe developed. With the aim of providing some additional background to put reporting into context, we investigate the origins of reporting requirements and common threads in current market practice.

Background

Reporting covenants originate from the Securities and Exchange Commission's (the "**SEC's**") periodic reporting requirements. The Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), requires certain companies to provide investors with information they need to make informed investment decisions. Companies subject to these reporting requirements are required to file a Form 10-K (an annual report), a Form 10-Q (a quarterly report) and a Form 8-K (a report required any time certain material events occur that affect the company). In addition, SEC rules and guidelines impose standards for drafting, such as the 'Plain English Rules' to ensure documents are accessible to investors. Moreover, the anti-fraud provisions of U.S. securities laws hold issuers liable for any material misstatements or omissions in disclosures to investors. Together, these formal requirements, rules and general exposure to liability create an environment in which issuers are required to disclose significant information about themselves and to do so with care. It is from this backdrop that the reporting covenants seen in European high yield bond offerings were born.

Why Do European Issuers Have Reporting Requirements?

Statutory Reporting for Rule 144A Transactions

Reporting covenants contained in the indenture serve as a contractual mechanism to ensure compliance with the information requirements of Rule 144A ("**Rule 144A**") of the Securities Act of 1933, as amended (the "**Securities Act**"). Where an issuer is not otherwise required to report pursuant to the Exchange Act (*i.e.*, a foreign company otherwise exempt or a foreign government), Rule 144A (the common resale exemption from U.S. registration used by issuers) requires the issuer to make available, upon request, certain "reasonably current" information. This information includes a description of the business, most recent balance sheet, profit and loss statement, retained earnings statement, and the previous two years' financial statements. Notably, this information requirement carries forward for each subsequent resale. Therefore, if an issuer fails to make such "reasonably current" information available to satisfy Rule 144A, investors would no longer be able to sell their notes without registration with the SEC or an alternative exemption. Reporting covenants therefore contractually protect liquidity of restricted securities by preserving investors' ability to make future resales in reliance on Rule 144A.

There are exemptions to the information requirements under Rule 144A, namely where the issuer otherwise reports information to the SEC or foreign securities regulators. More specifically, resale of securities are exempt from the information requirements of Rule 144A if the issuer files reports with the SEC pursuant to the reporting requirements of the Exchange Act or is exempt under Rule 12g3-2(b) of the Exchange Act (this exemption encompasses any foreign private issuer that, among other specific requirements, has listed equity securities outside the US and which complies with local disclosure regulations). Certain listed European high yield issuers may fall into these exemptions, but we believe most do not.

Investor Commercial Expectations for Information

Regulatory requirements aside, investors' baseline expectation is to receive sufficient reports to inform their investment decisions regardless of the formal regulatory requirements. For instance, despite the exemption available to foreign private issuers registered with the SEC from the requirement to file quarterly reports (they are only required to file annual reports on Form 20-F and notify the market of material information on Form 6-K), they do, nevertheless, often provide quarterly reports on Form 6-K. Similarly, market practice has developed such that issuers of European high yield bonds not subject to the information requirements of Rule 144A are nevertheless expected to provide quarterly reports and general information which closely correlates to such requirements. The information requirements of Rule 144A provide a floor for reporting and investor expectations set a higher bar. These investor expectations manifest in the reporting covenants found in European bond indentures.

Common Reporting Requirements under European High Yield Indentures

The following discussion describes the reporting covenants and requirements contained in the indentures for European high yield issuers, and their most common variations.

Annual and Quarterly Financial Statements

The indenture requires issuers to, within a certain number of days following the end of each year or quarter, provide financial information to investors. Such annual or quarterly information typically satisfies the information requirements of Rule 144A, namely by periodically providing a description of the business, balance sheet, income statement and statement of cash flows, but the indenture typically goes further to address investor expectations. Investors typically demand to see a periodic presentation of EBITDA and industry specific metrics, and, notably, require the issuer to provide such information on a shorter timeline and without the need for investors to request it.

Pro Forma Information

Reporting covenants also typically require a *pro forma* income statement and balance sheet in the event there were any acquisitions or dispositions during the period. However, these *pro forma* disclosures need not comply with Regulation S-X under the Exchange Act, instead the typical formulation of the covenant will require explanatory footnotes, which take on greater importance in this context.

While the annual, quarterly and periodic requirements derive from reporting requirements applicable to U.S. public companies the European bond market does not follow them strictly and has developed some distinctive features, which are largely common sense adaptations to the non-registered or European context that have evolved over time. For example, it is now common to note any acquisitions that occurred during the period rather than supply full *pro forma* financial information (only the target's financial information need be provided, to the extent reasonably available).

Business and Operations

In addition to financial information, the quarterly and annual reports are typically required to contain a management's discussion and analysis ("**MD&A**") section which discusses the financial results in greater detail. The MD&A often includes certain key performance indicators for the business, information on environmental and employment matters, a general discussion of the business, including a discussion of material transactions, contracts, risk factors and recent developments related to the company. However, requirements that were historically seen in European high yield indentures to draft these sections "with a similar level of detail to the offering memorandum" have largely fallen away.

Material Events Reporting

Similar to the requirements under Form 6-K, upon the occurrence of a material event, issuers are required to promptly provide a description of the event to bondholders. Examples of material events include a material acquisition, disposition or restructuring, a change in management or key employees, a change in auditors, or other similar events.

Flexibility in Reporting Covenants

While most items contained in the reporting covenant are relatively uniform across the market, like other aspects of a high yield bond, there is some degree of flexibility. This is important as the covenant needs to ensure bondholders receive information while also allowing the issuer to grow and adapt.

Reporting Entity - There is often flexibility about which level of the corporate structure should be the consolidating and reporting entity. Most indentures require the issuer to be the consolidating entity, but permit a parent entity to report if at any time the notes are guaranteed by any direct or indirect parent company. In the context of payment-in-kind ("**PIK**") deals, the financial disclosure requirements are often not at the level of the PIK issuer, but rather at an entity lower in the corporate structure. In this context the covenant would require an additional explanation if there is a significant difference in the financials if it had otherwise been reported at the PIK issuer level.

Treatment of Unrestricted Subsidiaries - One common point of flexibility relates to the issuer and its corporate structure. Which entities must report? Sometimes it is only the issuer and its restricted subsidiaries and sometimes it is all subsidiaries. However, where unrestricted subsidiaries are not included in a report, if when they are taken together they would otherwise be a significant subsidiary of the issuer, issuers are often required to have separate disclosure for them containing the same information.

Accounting Standards - Another common concern is which accounting standard is applied and as of what date (*i.e*., US GAAP or IFRS). The accounting standard is typically "floating" for reporting purposes, meaning it changes over time as the accounting standards change. However, when it comes to the application of the relevant accounting standard when calculating compliance with the covenants most indentures allow for a "freeze" of the standard as of the date of the indenture (or any date prior to such "freeze"). This allows the issuer some certainty as to how it will calculate its compliance. However, sometimes issuers are permitted to change the applicable standard (to incorporate new rules or interpretations) up to one or two times over the life of the bond. Notably indentures usually do not contain a specific requirement that the issuer report the metrics which it uses to measure compliance with the financial covenants, therefore, without notification from the issuer, a bondholder may not be able to confirm from a report based on "floating" accounting standards whether an issuer is able to take further actions under any incurrence covenants as they may have "frozen" the accounting standards which are applicable.

Public Companies - If an issuer or one of its parent companies does a public equity offering and thereafter is subject to a stock exchange's reporting requirements, the reporting covenants in the indenture may allow for a reporting change. This covenant has come in to greater focus in recent years and is very important to companies that may be considering a public equity offering in the near future (for additional information regarding the high yield to IPO process please see our article available at: https://www.whitecase.com/publications/insight/hit-ground-running-high-yield-bond-ipo). Certain reporting covenants provide that if the issuer or a parent entity is listed on a regulated market and the issuer fulfils that exchange's reporting requirements, the issuer is deemed to comply with the obligations under the reporting covenant. Other reporting covenants provide for more minor changes to reporting requirements following a public equity offering, for example, by requiring *pro forma* financial information only to the extent required by the stock exchange rather than *pro forma* income statement and balance sheet information for any material acquisitions, dispositions or recapitalizations.

It can be important to build in the relevant reporting flexibility into an indenture from the outset where an issuer may become a public company to avoid duplication of reporting requirements. For example, recently Worldpay Group delisted from the London Stock Exchange, the result of which was that Worldpay Group was no longer required to make its reports publicly available other than pursuant to its high yield indenture. Worldpay Group sought bondholder consent to shift their indenture reporting requirement further up their corporate structure to a new indirect parent, Worldpay Inc., which trades on the New York Stock Exchange (the "**NYSE**") and publicly files with the SEC. However, there was significant investor discussion around the change to the reporting entity and change of reporting requirements, and given the required reporting flexibility was not included in the indenture, ultimately Worldpay Group had to pay a consent fee to secure the amendment.

Investor Calls - Many indentures require the issuer to hold investor calls for bondholders. However, it is common to allow bondholders to participate in shareholder calls for issuers whose parent company is listed, rather than requiring separate investor calls for bondholders.

Conclusion

Overall, the aim of reporting covenants is to provide bondholders with "reasonably current" information to understand their investment and to preserve liquidity in the resale market. Thus far, the application of the Rule 144A based practice in the European high yield context appears to have achieved both of these aims. Although European issuers may be exempt from Rule 144A's information requirements, they normally provide information on a more fulsome scale than is required, allowing investors to have reasonably detailed visibility on their investments. However, issuers are still able to build in flexibility and adapt their reporting requirements to their specific needs. This approach has allowed for a successful market to emerge both from the perspective of investors and issuers.

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