CLEARY GOTTLIEB

Portability: Here Today, Gone Tomorrow

WHAT IS PORTABILITY?

High yield covenant packages have traditionally contained provisions that require the issuer to make an offer to all bondholders to purchase the bonds – generally at 101% of par – on the occurrence of a change of control (CoC). This reflects the premise that the ownership and management of the issuer are key investment considerations, and bondholders should have an opportunity to take a "second look" at their investment and potentially exit from it without loss if those should meaningfully change.

Portability refers to variations in conventional CoC provisions through which events that would otherwise constitute a CoC might not trigger the traditional bondholder put right.

By limiting the instances in which a CoC triggers a bondholder put right, portability facilitates exits by controlling shareholders – with the bonds thus becoming "portable," travelling with the issuer to the issuer's new owners without the need for refinancing arrangements. This flexibility is useful to controlling shareholders in many contexts, but can be particularly important to private equity sponsors, which are in the business of buying and selling controlling equity stakes.

There are two principal portability formulations:

Leverage-based formulations—in which an offer to purchase following a CoC typically need only be made if, on a *pro forma* basis after giving effect to the CoC, a specified leverage ratio would be exceeded; or

Ratings-based formulations—in which an offer to purchase following a CoC typically need only be made if specified adverse credit rating developments occur (or, at times, persist) within a specified period of time following public announcement of the CoC.

As leverage-based tests tend to provide earlier certainty as to whether an offer to purchase will be needed than ratings-based tests (which depend on determinations by credit rating agencies during a post-announcement period) and, potentially, more structuring avenues to avoid such an offer, they are generally viewed as more favourable to issuers and sponsors. To date, leverage-based tests have predominantly been seen in deals with private equity sponsors, while ratings-based tests have predominantly been seen in corporate deals, although there are exceptions.

RECENT TRENDS IN THE HIGH YIELD MARKET

Deals with portability features have proliferated in the European high yield market in recent years, although not without controversy. From bondholders' perspective, portability represents a dilution to important protections against the risk that acquisitions might be structured to their detriment or that their bonds might be re-priced downwards following acquisitions by more leveraged or riskier entities. For the most part though, investor pushback on portability in recent years has been sporadic and (with the benefit of hindsight) unsuccessful. Although the incidence of such features declined in 2015 (amidst particularly vocal investor pushback), it recovered quickly thereafter, and today remains a feature in over 1/3 of deals. Moreover, while some aggressive documentation features have moderated, other features initially viewed as aggressive have largely become standard (as discussed below).

KEY POINTS IN LEVERAGE-BASED TESTS

The principal negotiated points in leverage-based tests are the following:

One-time or multiple times—portability has historically been (and remains) a mostly one-time exception to the CoC put right. A minority of deals, however, continue to see "fully" portable constructs (despite being perceived as aggressive) in which the issuer can be sold and resold multiple times over the life of the bonds, avoiding the put right each time.

Step-downs and opening leverage levels—early leverage-based formulations often required a modest measure of deleveraging to access portability during an initial concessional period (typically, of 12 to 18 months), and still greater deleveraging (typically, a half turn of EBITDA) to access it thereafter. Increasingly though, deals tend to dispense with step-downs in favour of a uniform leverage test (regardless of when after issuance the portable CoC might occur) and, increasingly, set that uniform leverage level so as to require little (for example, less than a half turn of EBITDA), if any, deleveraging from opening leverage levels.

Net or gross leverage—net leverage tests (*i.e.*, net debt to EBITDA) in portability provisions have largely become the norm. This is despite concerns that leverage levels in net tests can be manipulated down through "structuring" injections of equity or subordinated shareholder debt. Although such injections are not necessarily problematic (as, regardless of intent, they are likely to lead to better capitalised, less leveraged issuers if the cash remains within the group), market practice has historically been mixed as to how to address concerns that injections made to access portability might prove to be transient. Approaches to address this have ranged from narrow exclusions that make clear that the injections themselves (if made with the intent of accessing portability) do not build up restricted payments room to complete resets of all restricted payments room if CoC portability has been exercised. The latter, more drastic, approach is aimed at concerns that, even if cash injections do not themselves build room, substantial other restricted payments room might otherwise still be available to facilitate immediate removal of such injected cash and, more generally, reflects the view that a CoC transaction should mean a fresh start for restricted payments capacity. Increasingly though, the market has settled on the narrow formulation.

EBITDA add-backs—whether to permit CoC transactions to be given *pro forma* effect in calculating ratios is often a negotiated point in portable issuances. The question assumes particular importance in the calculation of the leverage ratio in the portability test itself, since large anticipated cost savings and synergies related to the CoC transaction make it more likely (by boosting EBITDA) that the leverage test will be met (and the CoC put right circumvented as a result). Although express features can still be controversial, it is not uncommon to see similar outcomes achieved in less obvious ways through loosely cast *pro forma* adjustments (whether in EBITDA and ratio definitions or in "Limited Condition Acquisitions" provisions).

"Limited Condition Acquisitions" flexibility—early leverage-based portability tests needed to be met on the date of the CoC event to avoid triggering the CoC put right. Increasingly though, "Limited Condition Acquisitions" / "Financial Calculations" provisions permit the leverage test to be tested when definitive documentation for the CoC transaction is entered into, thus avoiding the CoC put right even if the relevant leverage level might not be subsequently met when the CoC event actually occurs (for example, because EBITDA declines or because cash has been depleted). This provides issuers and sponsors with certainty that portability will be available at an earlier stage, but has proven controversial with investors (as the original purpose of "Limited Condition Acquisitions" provisions was to increase certainty around acquisitions *by* issuers, not acquisitions *of* issuers).

KEY POINTS IN RATINGS-BASED TESTS

The principal negotiated points in ratings-based tests are the following:

Look-forward period—the period tends to begin on the date of public announcement of the CoC and end a specified number of days (often, 90 days) after the occurrence of the CoC. Often, but not invariably, the look-forward period will be subject to extension if the ratings remain on negative watch.

Ratings decline / withdrawal constructs—the most common formulations distinguish between instances in which, prior to public announcement of the CoC: (i) the bonds were rated investment grade by at least half (*e.g.* by 1 of 2, or 2 of 3), or in certain cases all, of the rating agencies that cover the bonds, and (ii) all other instances. In the former case, the CoC put right will typically be triggered if a specified number of the rating agencies initially rating the bonds investment grade reduce their rating during the look-forward period to a sub-investment grade rating. In the latter case, the CoC put right will typically be triggered if a specified number of the rating agencies downgrade the bonds during the look-forward period by a specified number of gradations (typically including changes within ratings categories, *e.g.*, + or – for S&P or 1, 2 and 3 for Moody's, but not changes in outlook). In deals where this construct is used, practice has historically been (and remains) mixed on the specified number of rating agencies that need to act in each case. Practice is also somewhat mixed as to the number of gradations by which the bonds must be downgraded in the latter case, although a trigger on a downgrade of even a single gradation is most common.

Causal linkage with the CoC—in certain ratings-based tests, the CoC put right is only triggered if, in addition to the requisite ratings declines, a causal connection is made between the CoC and the relevant ratings downgrades (including, in certain deals, express requirements that a such a connection is made clear in either public announcements by or private written confirmations from the relevant rating agencies).

"DISGUISED" PORTABILITY?

In addition to express portability provisions, a number of less visible developments in conventional CoC provisions (and related definitions) in recent years may make it less likely that exits by controlling shareholders will be treated as CoCs to begin with. These include, for example:

Acquiring vs. selling control: The beneficial ownership prong of the CoC definition, and the nature of the changes in beneficial ownership under it that are needed to trigger a CoC, have evolved over time. Traditionally, a CoC was triggered if specified permitted holders reduced their beneficial ownership below a certain threshold (typically 50%) – with variations for already-public companies or to cater for the possibility that the issuer might undertake an IPO during the life of the bond. At present though, it is almost uniformly the case that the formulation is flipped, such that a CoC is only triggered on the acquisition by a third party of a greater than 50% interest - which, in practice, may permit permitted holders to reduce their ownership of the issuer to levels significantly below 50% without the change of control put right being triggered.

Affiliates as "permitted holders": Key limbs of the "change of control" definition will generally not be triggered where the relevant sale is to, or the relevant acquisition is made by, "permitted holders." In recent years, the definition of permitted holders is typically extended to "affiliates." This represents a significant expansion of the universe of permitted holders who may acquire a controlling interest in the issuer, since affiliates, as typically defined, could include entities in which controlling parties on the issue date have a stake as low as 10%. (This, in effect, could permit principals to reduce their holdings by 90% with relatively modest structuring steps without triggering a CoC.) Moreover, issuances with formal portability features often build on the above by extending the permitted holders definition beyond affiliates of the principals on the issue date—to any person or group that acquires control of an issuer in a CoC that doesn't trigger the CoC put right (because of formal portability), as well as *their* affiliates. As a result, even in issuances with one-time portability, relatively modest structuring steps can often provide significant flexibility for subsequent re-sales without the CoC put right being triggered.

Looser "successor holding company" carve-outs: Successor holding company carve-outs have becoming looser over time. From provisions intended to facilitate insertions of holding companies above the issuer in circumstances in which ultimate beneficial ownership would not meaningfully change, these have evolved into more sweeping constructs that negate the occurrence of a CoC if any acquiror – either of the issuer's equity or, sometimes, substantially all of its assets – is not *itself* majority-owned. This of course makes it unlikely that an acquisition by a widely-held public company would be viewed as a CoC (even though the management and direction of the issuer may fundamentally change as a result of the acquisition).

PORTABILITY IN THE LEVERAGED LOAN MARKET

Although the European leveraged loan market has not been immune to tweaks and innovations in CoC provisions (and related definitions) of the sort discussed above, express portability provisions remain relatively rare (and are still perceived as highly aggressive). This is because, unlike high yield bonds, leveraged loans are typically repayable at par by the borrower in connection with a CoC transaction. This broadly mirrors a similar lack of traction for such features in the US high yield and Term Loan B markets.

Where such formulations are found in European leveraged loans, typical formulations entail a leverage test (with leverage levels often set below any leverage-based maintenance covenant), single-use constructs within a specified period (typically 12 to 24 months after closing), preapproved white lists of acceptable buyers (and, occasionally, where there is greater flexibility, restrictions on types of buyers, such as distressed debt funds) and requirements intended to facilitate lender "know your customer" (KYC) and diligence on the prospective acquiror and transaction.

DEAL CONSIDERATIONS

1. Is a portability provision appropriate in the context of the deal (and the market climate), and if so, should it be leverage-based (primarily sponsor deals) or ratings-based (primarily corporate)? ☐
2. Are the specific drafting choices (particularly, in leverage-based tests, single- vs. multiple-use, leverage levels, and interactions with EBITDA add-backs and "Limited Condition Acquisitions" provisions) optimal in light of the ownership structure, shareholders' likely exit plans and related messaging to investors? ☐
3. Have the specific drafting choices in the CoC (and related) definitions been carefully considered to reflect the considerations noted above? ☐

OUR TEAM

David Billington
Partner
London
+44 20 7614 2263
dbillington@cgsh.com

Pierre-Marie Boury
Partner
London
+44 20 7614 2380
pboury@cgsh.com

Ian Chin
Associate
London
+44 20 7614 2280
ichin@cgsh.com

Aseet Dalvi
Counsel
London
+44 20 7614 2218
adalvi@cgsh.com

Carlo de Vito Piscicelli
Partner
Milan and London
+39 02 7260 8248 /
+44 20 7614 2257
cpiscicelli@cgsh.com

Valérie Lemaitre
Partner
Paris
+33 1 40 74 68 00
vlemaitre@cgsh.com

Michael Kern
Senior Attorney
Frankfurt
+49 69 97103 252
mkern@cgsh.com

Matthew Podger
Associate
London
+44 20 7614 2247
mpodger@cgsh.com

Andrew Shutter
Partner
London
+44 20 7614 2273
ashutter@cgsh.com

clearygottlieb.com

18.1122.03_120318