

19 The Development of High-Yield Documentation

By Christopher Kandel and Matthew Dunlap

Introduction

While the origins of the market for high-yield notes – corporate bonds with below investment grade credit ratings – go back decades, the modern market first developed in volume in the US in the 1970s. This was based partly off the back of research by Walter Hickman, a former president of the Federal Reserve Bank of Cleveland, that showed a diversified portfolio of high-yield debt overcompensated for the increased default risk over a diversified portfolio of investment grade debt, and efforts by Drexel Burnham Lambert and its sales and trading force, led by Michael Milken, to publicise this to portfolio managers.

Brief history of the high-yield market

The US investor market had grown by the early to mid-1980s to the point that high-yield notes were a staple of the US leveraged finance market, part funding many of the leading LBOs in the US of that period and incidentally giving rise to a number of questionable practices that ultimately led to the collapse of Drexel in 1990, and a decline in that market for a relatively short period, after which it resumed its growth and continues to be a success story to this day.

By comparison, the European investor base for high-yield developed relatively slowly. The initial European high-yield issuances of the 1990s were mostly by cable and other telecommunications companies and were denominated in US Dollars (sometimes called ‘yankee bonds’) and placed mostly in the US, with relatively isolated issuances in European currencies. Estimates were that approximately two-thirds of issues were still being purchased by US-based investors as late as 1999. However, the European investor base was growing and had matured sufficiently by 2000 that there were estimated to be over 100 regular institutional investors in Europe investing in high-yield.¹

The establishment of the euro in January 1999 was a landmark, and the first part-euro denominated high-yield issues made their appearance that year (for example Netia, featuring a US Dollar and euro tranche), with a few smaller and entirely euro issues in 2000 believed to have been placed largely with European investors.

1. Edward B. Flowers and Francis E. Lees: *The Euro, Capital Markets, and Dollarization*, Roman & Littlefield Publishers, Inc. (2002), pp. 98-99.

Trends from the US

US high-yield was traditionally unsecured and issued by the same issuer/borrower as the more senior loans to the issuer's group, and the high yield usually benefited from upstream guarantees from the same guarantors as the loans. In the early days, US high-yield was often contractually subordinated and therefore called 'senior subordinated notes', but increasingly this feature was dropped and the more senior lenders in the US relied on their security rights and US Chapter 11's automatic standstill on creditor action, to ensure their priority. As a technical matter, this contractual subordination rarely required an intercreditor agreement because the US market was comfortable with relying on third party beneficiary rights under New York law, so the subordination (when it featured) went directly in the indenture under which the notes were issued.

Another historical feature of US high-yield is that, for speed of placement reasons, the high-yield notes initially would be privately placed but then exchanged in an exchange offer for notes that were registered with the US Securities and Exchange Commission (the right to have this done is referred to as 'registration rights'). As a result, the high-yield issue needed to comply with the requirements of US law applying to registered securities, the most important of which for the purposes of this chapter is the US Trust Indenture Act. This Act prohibits standstills on enforcement, so US high-yield issues (whether or not contractually subordinated) do not feature standstills on enforcement. The consequence of this in the US is not material, because any move to enforce normally results in a Chapter 11 filing, with its associated automatic standstill on most creditors, including, of course, the high-yield noteholders and loan lenders.

European high-yield takes shape

European high-yield during its early phases was also usually unsecured (as well as unguaranteed), although it might benefit from security over the shares of the issuer and any on-loan of proceeds from the high-yield issuance. Senior lenders in the earliest deals sounded out obtaining contractual standstills along the lines of what they were familiar with in the European mezzanine market, but this was not able to be accommodated due to the fact that the early European high-yield (and most European high-yield until the early 2000s) continued to feature registration rights and therefore a need to comply with the US Trust Indenture Act's prohibition on contractual standstills. There was also a marketing question as to whether US investors would accept this change from the US norm.

Senior lenders in Europe found this hard to accept, given differences in European insolvency regimes from the US (including in particular the absence of standstill provisions in many cases and the relatively liquidation-oriented nature of some European insolvency laws) and the relatively 'leaky' nature of security in many jurisdictions. So for deals where it could be structured in this way, the senior lenders' response was to require the high-yield to be structurally subordinated – in other words, the senior lenders required the notes to be issued by a holding company with no upstream credit support from obligors in the banking group. The result is that the high-yield noteholders could, on a default, tip the issuer into insolvency proceedings, but would still leave the operating companies able to continue trading and – perhaps most importantly to the senior lenders – able to be sold as a going concern in a share pledge enforcement if needed.

Where the proceeds of a high-yield issuance are on-lent into an operating group on a basis intended to be junior to the senior bank loans, it is of course necessary to contractually subordinate such proceeds even when otherwise the high-yield issue is structurally subordinated. Interestingly, the European market was and remains less comfortable with third party beneficiary rights in achieving subordination, so from the beginning, and as a contrast to the US market, it normally required the trustee for the high-yield issue to become party to an intercreditor agreement.

A number of European high-yield issues restructured in the early 2000s following the collapse of the so-called 'dot.com' bubble. It was not lost on investors that recoveries in the US market following high-yield defaults significantly exceeded recoveries in the European market in the restructurings. There has been a debate since then whether the losses were a result of the European structural subordination or the fact that the high-yield issues in question had been used to fund what effectively were start-ups, particularly in the then crowded cable and fibre optics field, but in any event the European market ground to something of a halt in 2002, culminating in a famous letter to investment banks from a dozen UK-based investors demanding upstream guarantees (albeit contractually subordinated and with built-in standstills) for the high-yield. After a relatively short stand-off, the market capitulated to these demands, with the Brakes Brothers issue in 2003, and started growing again.

Evolution of 'super senior' and 'pari-passu' structures

A landmark deal occurred in 2005, when Cablecom's bankers Deutsche Bank and Goldman Sachs proposed to Cablecom that it could replace its senior secured term loans entirely with operationally less restrictive high-yield that was not subordinated in any way (structurally or otherwise) and in fact had the same security as the term loans being replaced. The relatively small revolving facility that remained was given additional and liquid security beyond what it shared with the high-yield, so was 'super senior' in this respect, and its covenant package – in other words the restrictions imposed by it on the issuer and its subsidiaries – was largely conformed to the high-yield notes covenants. This created a new product in Europe – the first 'super senior revolver and senior secured notes' structure of its kind.

The super senior revolver structure evolved from this starting point, so that instead of having separate additional collateral, the revolving facility simply shared in the overall security package (with any separate security) but on a priority basis to the senior secured notes, discussed further below. So as not to subordinate the high-yield notes, the super senior revolver remained 'pari passu' as a contract claim.

The market continued to grow until the Financial Crisis and deepened with the collapse of Lehman Brothers in 2008. In 2009, a further innovation in the European market occurred when, for the first time, Virgin Media issued senior secured notes, but this time alongside senior secured term and revolving loans, sharing all security with the notes on a pari passu basis and not second in waterfall priority or subordinated in any way. The proceeds of the notes issuance in that and the other vanguard issuances of this kind were actually used in part to repay the banks, which were making the senior secured loans available, so were a net reduction in exposure for the banks.

The bank/bond pari passu product further evolved with 2010's CVC led acquisition of Sunrise, the Swiss telecoms group, where pari passu senior secured notes and senior secured term loans were for the first time used to finance an acquisition in Europe, and these (the so-called 'pari passu structure') and the Cablecom style notes (the so-called 'super senior structure') have gone from strength to strength during the course of this decade, particularly for the largest acquisition financings.

Documentation and the publication of the LMA high-yield documents

The super senior structure led to a significant amount of negotiation and variation in terms, largely arising out of a number of factors:

- The facility agreement was a revolving facility only, with the restrictive covenants and sometimes certain other features stripped out, and replaced with New York law interpreted covenant schedules that duplicated the associated senior secured notes terms, with modifications only for the difference in structure. The changes required from the LMA's usual forms were mechanical but time consuming.
- Intercreditor terms were more difficult:
 - The super seniority of the revolving facility evolved, and more or less settled on being first in the waterfall for security enforcement proceeds and proceeds of distressed disposals of collateral. However, the need to be first in the waterfall for any other enforcement proceeds (e.g. under guarantees and the like) came under dispute, due to concerns that this would result in subordination of the notes (with an associated marketing impact if they needed to be called 'senior subordinated notes'). In addition, major institutions in the market had very different (and sometimes inconsistent) approaches on the detail, including whether any forms of standstill should apply following an acceleration.
 - There was much variation and negotiation over who controlled security enforcement, when and for how long, and whether there should be any consultations between secured classes. On the one hand, the senior secured noteholders were concerned that the revolving lenders would be incentivised to undertake a fire sale resulting in proceeds for them but less than a fair recovery for the noteholders. The revolving lenders, on the other hand, were concerned that noteholders would not be able to organise themselves and act sufficiently quickly, or might have an incentive to do nothing for an extended period and hope the issuer would trade back up.
 - Out of this arose detailed provisions, taking different approaches in form but with similar results, i.e. a six month initial period where the noteholders have control, with that right flipping early to the revolving lenders after a period of time (typically three months) if the noteholders have not taken any enforcement steps, or in some cases of insolvency.
 - Security enforcement principles were agreed, giving comfort on the fairness to the senior secured noteholders when enforcement was to be driven by the revolving lenders, but also took many forms in terms of detail.
 - Some, but not all, intercreditor agreements also built in the flexibility for a parallel issue of senior unsecured notes, usually, but not always, on a structurally subordinated basis, with all the additional complication that entailed.

The LMA waited until a certain commonality had developed within the market for the super senior revolving facility agreements and intercreditor agreements, and then organised a working group of loan and high-yield lawyers, bankers and investors to work with it in developing forms to serve as a common starting point from which market participants could negotiate, introducing market efficiencies. Over the course of part of 2013 and 2014 and much debate, forms were prepared and published. These include a form of super senior revolving facilities agreement and two forms of intercreditor agreement (one version with senior unsecured notes alongside senior secured notes, and the other with just senior secured notes).

The LMA also published an intercreditor agreement for 'leveraged acquisition finance transactions (super senior/senior)' which is designed as a starting point for super senior revolving facilities alongside term loans but not high-yield notes. This is designed for the unitranche market and is not further addressed here.

An interesting development in the market over the past eight years is an acceptance of 'future-proofing' intercreditor agreements, where the inclusion of flexibility for future debt in an intercreditor agreement can be good for pari passu debt structures, or even debt structures without any high-yield notes in them, largely by reducing the need to amend the intercreditor agreement when a new financing is contemplated. The starting point for quite a number of these deals is the LMA's intercreditor agreement for super senior/high yield structures, but with the super senior feature eliminated or at times springing when no term loans are left in the structure, and the very different market construct for pari passu voting on security enforcement construct included. These typically also provide for second-lien debt, including second-lien notes.

Looking to the future

The robustness of the high-yield market has clearly increased with time and particularly since the Financial Crisis – formerly, it was the sick man of Europe, the first debt market to constrict in the face of market issues (particularly equity market issues). Following the Financial Crisis, once the high-yield market reopened, it went from strength to strength, while the loan markets remained constrained to a degree by banks dealing with capital issues arising from the losses suffered during the crisis. This has been evidenced more recently by the reaction of the high-yield market to the global economic and social impacts of Covid-19. The closure of the high-yield markets in the US and Europe in March 2020 was short lived, with the US market re-opening at the end of March 2020, followed shortly thereafter by the European high-yield market, which sprang back to life in April of that year. In fact, according to Debtwire, while the number of issuances in 2020 was slightly lower compared to 2019 (192 in 2020 vs. 224 in 2019), the value of European high-yield issuances increased by approximately 10.5%, from approximately \$102bn in 2019 to \$113 bn in 2020. The recovery continued in the first quarter of 2021, with approximately \$47bn of European high-yield issuances via 82 issuances compared to approximately \$25bn in the first quarter of 2020 via 42 issuances. The European high-yield market recovery reflects the continued strength and maturity of the asset class. Looking ahead, the high-yield market will need to do what it has always done, navigate macroeconomic and geopolitical factors, including the rising spectre of inflation, the likelihood of rising interest rates in the near to mid-term, significant corporate debt loads and ongoing political ructions in the US and Europe, to name but a few.