

Loan Covenant Checklist: Restricted Payments

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A Checklist of issues for counsel to consider when drafting or negotiating a restricted payments negative covenant in a loan agreement. These include the scope of the covenant and parameters of typical permissive baskets.

In its simplest formulation, a restricted payments covenant in a loan agreement limits the borrower's (or its parent company's) ability to make payments in the nature of dividends, distributions, equity redemptions and repurchases from its equity holders. The provision ensures that equity holders are not paid before the loans are repaid, apart from limited exceptions. Generally, a borrower's obligations under a loan agreement are senior in priority of payment to any obligation that the borrower may have to its equity holders. Other types of payments to parties that are not equity holders may also be covered in a restricted payments provision, such as payments to holders of the borrower's subordinated debt.

For a standard form of restricted payments provision, see *Standard Clauses, Loan Agreement: Limitation on Restricted Payments Negative Covenant* (<http://us.practicallaw.com/9-501-7208>). For more information about negative covenants in loan agreements, including the restricted payments covenant, see *Practice Note, Loan Agreement: Negative Covenants* (<http://us.practicallaw.com/5-383-3077>).

GENERAL CONSIDERATIONS FOR DRAFTING AND NEGOTIATING THE COVENANT

Although much of the negotiation of a restricted payments covenant in a loan agreement focuses on the baskets that permit the borrower to make restricted payments in specific circumstances, begin drafting or reviewing the covenant by considering:

- **The scope of the covenant.** The restricted payments covenant customarily restricts returns to equity holders, such as dividends, distributions and share repurchases. Unless covered in a separate covenant, the restricted payments covenant also customarily restricts payments on junior debt. Junior debt typically means subordinated debt, though a borrower's junior lien debt is also made subject to the restricted payments covenant of the senior lien loan documentation, and payments on *pari passu* debt are sometimes covered as well. Sometimes payments of management fees to sponsors are also covered. Although this is rare, in some loan agreements the restricted payments covenant is patterned after a high yield indenture and also covers payments that relate to "restricted investments," essentially merging the investments covenant into the restricted payments covenant. Counsel should ensure that the permissive baskets correspond to the various types of payments restricted by the covenant.
- **The parties affected by the covenant.** Often the covenant applies solely to the borrower and its subsidiaries (or restricted subsidiaries), but not any upper-tier holdco. In this case, allowing the borrower to make restricted payments allows funds to be taken outside the scope of the loan agreement's covenant package unless there are restricted payment-blocking covenants in a parent guaranty or other document binding the parent. However, if there is a parent guarantor, it may be included in the scope of the loan agreement's covenant. If this is the case, scrutinize each basket to ensure that if funds are intended to be upstreamed from the parent (such as tax distributions if the borrower and parent are flow-through entities) the parent is permitted to do so.



- **Existing credit facility covenants.** If the borrower's direct or indirect parent has credit facilities or notes outstanding, determine whether the applicable debt documentation contains a limitation on restrictive covenants. Such a provision could prevent the borrower from being bound by a restricted payments covenant absent a waiver or amendment from the lenders under the parent's credit facility.
- **What defaults should block access to baskets.** Beyond amount caps and financial ratio or other financial tests that can limit the borrower's ability to make restricted payments, many loan agreements provide that restricted payments are blocked during a default or an event of default, or sometimes during a limited list of events of default, such as a payment default, bankruptcy or failure to maintain existence. Lenders may seek to impose blocks during any default, while borrowers want to narrow the block as much as possible, if not eliminate it. Not all baskets need be subject to the same block. For example, restricted payments:
 - under a general building or incurrence-test-based basket might be blocked during any default;
 - for sponsor management fees might be blocked during any event of default;
 - for reimbursement of a sponsor's out-of-pocket expenses might be blocked during a payment or bankruptcy default; and
 - for tax distributions might not be blocked at all.
- **Interplay with excess cash flow definition.** Restricted payments do not reduce the borrower's net income or EBITDA, but they do represent a cash outflow. Accordingly, borrowers may seek to deduct restricted payments under as many restricted payment baskets as possible from the calculation of excess cash flow in loan agreements with an excess cash flow sweep. Lenders should carefully evaluate requested deductions as these payments may be made before excess cash flow is swept and used to pay down the loan principal. Only a minority of loan agreements allow for payments under a general, discretionary restricted payments basket to be subtracted from the excess cash flow calculation. Some deductions are technically warranted, such as a deduction for tax distributions, since if the borrower were paying its own taxes those would already be deducted in arriving at net income (or, if the excess cash flow formula is based on EBITDA, would be agreed as a non-controversial deduction). Other deductions are a matter of business negotiation.

Some loan agreements add an express qualifier that permits the deduction of certain restricted payments baskets from the calculation of excess cash flow, but only to the extent the amounts are paid with internally generated cash flow (as opposed to borrowed under the revolver or under other permitted debt facilities).
- **Interplay with consolidated net income/EBITDA definition.** Some restricted payments to a parent entity will typically be permitted on the theory that they are intended to cover costs and expenses that would be paid by the borrower if it were not a subsidiary of the holdco parent entity, such as corporate overhead. In those cases, if the holdco is not within the consolidated group for purposes of calculating consolidated net income and EBITDA, lenders will want to scrutinize those definitions – if the expenses are "displaced" onto the holdco parent entity but paid for by the borrower, they may need to be deducted out of consolidated net income or EBITDA to avoid inflating earnings (for example, in calculating an earnings-based building basket). This issue may be mitigated or eliminated if the borrower is required to reflect the relevant expenses in its income statement under "push down" accounting principles.

RESTRICTED PAYMENTS BASKETS

Negotiated exceptions to the loan agreement's prohibition on restricted payments are typically contained in baskets in the restricted payments covenant. These baskets give the borrower (or other loan parties) permission to make restricted payments for particular purposes, subject to any specified limits or restrictions. Loan agreements commonly include baskets for the following purposes:

- Taxes (see *Taxes*).
- Expenses and parent company overhead (see *Expenses and Parent Overhead*).
- Repurchases of shares in the borrower (or applicable parent company) from directors and officers (see *Share Repurchases from Officers and Directors*).
- General purpose restricted payments (see *General Basket*).
- Other restricted payment purposes (see *Other Baskets*).

TAXES

Where the borrower is a flow-through entity or a member of a consolidated group for tax purposes, the borrower will likely need to upstream funds to its direct or indirect parent(s) for the payment of income tax obligations attributable to it.

- **Identify the tax-paying entities.** If the covenant applies to one or more parent entities as well as the borrower, confirm whether those entities also need permission in turn to upstream the funds, or whether they pay their own taxes and have no need to further upstream the funds).
- **Typical formulations.** The basket for tax distributions is typically capped in amount, by reference either to:
 - the amount of tax that the borrower (or parent, if applicable) would be required to pay as a stand-alone entity; or
 - the borrower's taxable income multiplied by the highest combined federal, state and local income tax rate applicable to corporations or individuals.

It is not customary to block the payments of tax distributions during a default, though a small minority of loan agreements do so.

- **Consult tax counsel.** When dealing with tax-related provisions, always obtain input from tax specialists.

EXPENSES AND PARENT OVERHEAD

Where a direct or indirect parent company of the borrower depends on the borrower's cash flow to defray some or all of its expenses, certain customary baskets allow the borrower to upstream funds to the parent for that purpose, for example:

- **Existence.** Funds for paying franchise taxes and other amounts necessary to maintain corporate or legal existence are generally allowed to be upstreamed without blocks or caps.
- **Overhead expenses.** A basket for funding the parent's overhead expenses (or the allocated overhead attributable to the borrower) typically contains qualifiers that limit the borrower's ability to make payments for expenses to expenses arising in the ordinary course of business, or expenses that are reasonable and customary. This basket may also be capped, such as by a fixed dollar amount annually.
- **Indemnity payments.** Some loan agreements include a basket to cover indemnification payments that the parent might be required to make, for example to its officers and directors. This is often handled separately from general overhead payments and is generally not capped in amount.

SHARE REPURCHASES FROM OFFICERS AND DIRECTORS

- **Identify the share-issuing entity.** If the borrower intends to repurchase management shares that are issued by the borrower, then the borrower typically repurchases the shares directly. If the management-held shares are shares issued by an upper-tier entity, the borrower needs to make a restricted payment to that entity in an amount sufficient to enable the upper-tier entity to repurchase the shares.
- **Determine the amount cap.** This basket is typically capped, usually at a fixed dollar amount per year or over the life of the loan agreement. Carryovers of unused amounts are customary and, in some agreements, the basket may be increased by the amount of proceeds of shares sold to management and by the proceeds of key man insurance policies. A minority of loan agreements, in lieu of a dollar cap, limit the borrower's ability to repurchase shares from its directors and officers by reference to an existing management equity plan.
- **Identify managers eligible for repurchase.** Borrowers often seek to include repurchases from continuing existing management, as well as repurchases that are triggered by death, disability, termination or other departure.

GENERAL BASKET

- **Core basket.** There are several common formulations for the core of the general-use restricted payments basket, where one is included. From the least to the most borrower-favorable, these are:
 - a fixed amount (per year or over the life of the loan agreement);
 - a building basket based on the portion of excess cash flow remaining after the excess cash flow sweep (or on some portion, typically 50%, of the borrower's cumulative consolidated net income) and usually also subject to a financial ratio test; or
 - an uncapped amount subject only to a financial ratio test.

In a building basket (or ratio-based basket), a "starter amount" is sometimes made available that permits the borrower to make restricted payments up to a fixed dollar amount even before the basket has begun to build (or without meeting the financial ratio test). Note that asset-based loan agreements often subject the general restricted payments basket to an excess availability test rather than a financial ratio test.
- **Expanders.** A general-use basket based on a building basket is often increased by the amount of proceeds from equity issuances or contributions to capital. Less frequently, conversions of debt to equity, returns on certain investments or declined proceeds from mandatory prepayment offers also increase the amount of the basket. These types of expanders have their origins in customary terms of high-yield indentures.
- **Shared basket.** A building basket is sometimes shared with baskets in other covenants, typically baskets for investments and junior debt prepayments. The use of a shared basket for different covenants may be subject to different tests, such as a less stringent financial ratio test when the basket is used to make investments rather than restricted payments, because when the borrower uses funds to make an investment the value remains within the corporate group. However, the use of builder basket for any of these covenants reduces capacity under the basket for all of them.

OTHER BASKETS

- **Stovepiping baskets.** Some restricted payments covenants allow for some types of transactions that increase the equity value of the credit group to provide capacity for restricted payments that remove up to an equivalent amount of value from the group. For example, proceeds of an equity issuance or a cash equity contribution may be used to make restricted payments. Sometimes the restricted payment must be made concurrently with, or within a specified period after, the equity issuance or contribution. Lender's counsel should ensure that these baskets do not result in double-counting. For instance, if an equity issuance creates restricted payment capacity under such a basket, it should not then also count toward an expander of the general-use building basket.

- **Technical baskets.** Some restricted payments covenant baskets are intended to handle transactions that nominally involve restricted payments but by their nature are generally (though not universally) accepted to be outside the scope of what is intended to be restricted by the covenant. Examples include:
 - restricted payments by subsidiaries (ratably to all owners, in the case of subsidiaries that are not wholly owned);
 - deemed repurchases of equity that occur on the exercise of options or warrants if shares must be tendered as part of the exercise price;
 - restricted payments consisting solely of the issuance of equity interests (other than debt-like preferred equity interests); and
 - cash payments in lieu of the issuance of fractional shares in connection with stock conversions, splits or reverse splits.
- **Convertible debt.** Public borrowers that have issued, or are considering issuing, convertible debt need to consider how payments made upon conversion will be handled in the restricted payments covenant baskets. Many loan agreements allow for cash payments in lieu of issuance of fractional shares, as mentioned above. However, this does not provide for the common practice of cash-settling the conversion in its entirety (not just fractional shares) to avoid dilution to the equity. Some loan agreements accordingly provide for a basket for such payments upon conversion, capped at the principal amount of the convertible debt being converted, plus any amounts realized on related hedging transactions that are settled or terminated concurrently with the conversion. To the extent that the borrower enters into equity hedging transactions, payments of a premium under those transactions may also need to be separately permitted under the restricted payments covenant. Lenders, meanwhile, should ensure that this basket does not result in duplication with a building basket that increases in the amount of any debt that is converted into or exchanged for equity.
- **Upstream or equity financing baskets.** The ability of the borrower or its parent to issue equity or incur additional debt raises questions about restricted payments intended to service such equity or debt. Loan agreements may contemplate either:
 - a direct or indirect parent of the borrower incurring structurally subordinated debt or issuing equity, in which case a restricted payment basket may be negotiated to allow the upstreaming of funds to service that debt or equity; or
 - the borrower itself issuing equity directly, including preferred equity that requires the borrower to make ongoing payments of a fixed dividend, in which case a restricted payments basket may be negotiated to permit the payment of preferred dividends.

A customary cap on these payments, where they are allowed, is 6% annually of the amount of proceeds received by the borrower from the issuance of debt or equity, a cap that is imported from the high-yield market. Some restricted payments covenants also allow for the reimbursement to a direct or indirect parent of expenses incurred in connection with a financing transaction on behalf of the borrower, whether or not the transaction is successful. If a financing is successful, fees are typically paid at closing from the proceeds of the financing, so this basket is used by a borrower to pay fees arising from transactions that did not proceed to closing.

- **Regular quarterly dividends.** For public companies that pay a regular dividend or are close to instituting one, loan agreements sometimes include a separate basket for the payment of a regular quarterly dividend. This basket is usually capped at a fixed dollar amount per year, without the borrower having to meet any financial ratio test to make the payment. Borrowers sometimes request this permission so they can be sure of their ability to pay a regular dividend once one has been instituted.
- **Declared dividends.** For public companies, loan agreements generally permit the payment of dividends that have been declared, within 60 days of the date of declaration, if the payment would have been permitted on the date of declaration.
- **Transaction-specific baskets.** In a financing that relates to another transaction, such as an acquisition or corporate (or financial) restructuring, consider what other aspects of the transaction might constitute a restricted payment and ensure that each is covered by an appropriate basket.

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