Special Comment

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Request for Comment on Moody's Indenture Covenant Research & Assessment Framework

Summary Opinion

This document requests comment on Moody's proposal to introduce a new covenant research and assessment framework. Moody's proposes to implement a more systematic approach to the analysis of indenture covenants and also to provide specific commentary on the relative protection such covenants provide.

Moody's will also report on market norms, which may vary over time, by sector, and by region.

Bond investors have become increasingly concerned about event risk and the absence of meaningful covenants in bond indentures, leaving them exposed to potential credit losses. In the current market environment, many companies face both internal and exogenous pressures to reward shareholders, often at the expense of bondholders.

Well-constructed covenants can provide bondholder protection in this environment, particularly in regard to event-driven credit risk. In Moody's view, event-related restrictions are critical to bond-value preservation, assuming carve-outs are modest and are based on a firm's need in the course of normal business. Strong covenants have already been shown to be effective in protecting bondholders in several instances, such as in the case of Ashland; conversely, weak or limited covenants do not adequately protect against credit deterioration in other instances, such as those of Sungard, First Data, VNU and Telstra Corp.

In light of this situation, Moody's has identified several key indenture covenants that can help protect investors against event risk, and it has also developed a framework for assessing their strength. This framework includes general guidelines on the most effective provisions, as well as a mapping grid designed to evaluate the relative strength of each covenant package.

We are assuming that covenant assessments will be most useful to investors considering new bond issues. Therefore, our covenant research would initially comprise "point-in-time" assessments of newly issued securities, with ongoing monitoring of covenants in only very limited circumstances.

Moody's will endeavor to evaluate the covenant mix of an issuer to ascertain what comfort can be derived from a given covenant package, ranking its quality as well as the risks associated with its absence.

In order to open this vital issue up to the fullest possible discussion and develop a framework most useful to investors, Moody's invites public comment on the following topics related to bond covenants:

- How important are covenants in bondholder investing decisions and to what extent would covenant assessments from Moody's be useful in these decisions?
- Should Moody's highlight situations where detailed covenant information is not available at the time an assessment is published?
- Is it preferable for Moody's to summarize the strength of individual covenants with a score or ranking, or should our assessment focus only on providing commentary on an indenture's overall covenant package?
- Are there other covenants not discussed in this Special Comment that would be of particular interest to investors?
- For which rating categories or for what type of securities would covenant research and assessment be most valued by investors?
- Is it sufficient to comment on covenants only at the time of issuance and in special situations?
- Are investors interested in Moody's provision of information on covenant documentation?

Moody's welcomes feedback and/or suggestions from interested market participants. Please send your comments to cpc@moody.com by October 12, 2006.

Overview

Moody's believes that appropriately structured debt covenants can reduce the agency costs associated with shareholder-creditor conflicts of interest and protect bond investors from event risk.

Historically, Moody's rating process has included a careful analysis of covenants contained in bond indentures. Moody's traditional approach has been to concentrate on those instances where a change in covenants would likely have an impact on the rating outcome, or where investors would have a particular interest in an indenture's covenants or lack of covenants. (This approach is discussed in detail in our Rating Methodology: *Moody's Approach Toward the Analysis of Indenture Covenants*, published October 1999.)

Typically, as companies move down the rating scale, an increasing level of covenants should impose greater discipline on corporate debt issuers. Moody's believes, however, that more aggressive corporate strategies and diminishing document protection are both adversely affecting the position of the bondholder vis-à-vis the shareholder. This has even prompted last-minute covenant changes, with clauses being hastily inserted to protect the bondholder against post-issue M&A activity (e.g. BAA, Clariant, Tyson Foods, Cintas, Expedia).

The increasing roles played by shareholder activists and private equity firms are now affecting the stability of the investment-grade landscape. During 2005, for instance, 46% of fallen angel rating actions by Moody's were driven by leveraged buy-outs, mergers, and share re-purchases. Some notable examples include: Sungard, Kerr-McGee, Basell B.V., and TDC A/S. As of March 31, 2006 fallen angels, as a result of M&A,/decapitalizations/share buybacks, include Pioneer Natural Resources, Affiliated Computer Services, Certegy, Hilton Hotels CBRL Group and Hertz Corporation. Companies are beginning to experience both internal and external pressures to more favorably reward shareholders -- but these often come at least partly at the expense of bondholders.

Large corporates seem particularly vulnerable at the present time to negative event risk. Evidence is mounting that private equity firms or buy-out consortia consider large public companies attractive prey. Notably, private equity transactions were up 18% in 2005 from 2004 to $500 billion. Lehman Brothers projects $600 billion to $750 billion for the global market in 2006 and expects some migration of investment-grade issuers to high yield as shareholder activists -- in particular, hedge funds, appear focused on the public investment-grade universe.

Recent examples of event-driven downgrades to high yield in the US and Europe include SunGard and TDC A/S. These transactions alone resulted in $23 billion in non-investment grade debt. In Asia, the debt of Telstra Corp, one of Australia's largest debt issuers, was downgraded from Aa3 to A1 due to the adoption of aggressive capital management initiatives. Other research predicts strong continued interest in larger size transactions and focus on public companies. Additionally, risk tolerance appears considerable as LBO leverage multiples for 2005 were higher than any year since 1998 (LCD).

Certain investors continue to lobby for improvements in covenant protection, but a number of factors currently favor the corporate debt issuer, such as ample global liquidity and a benign credit environment. For example, European investment-grade indentures currently only provide very limited protection for investors. They include cross-default clauses with sizable thresholds and negative pledge clauses that often refer only to trade debt and also include substantial carve-outs. Certain representative bodies, including market participants, have made public proposals with specific suggestions to address the shift in credit quality and documentation standards.[1]

Managements of investment-grade level companies are introducing exogenous risk, both contractually (fewer, and typically weak covenants) and by virtue of more aggressive corporate strategies. Investors would welcome an improvement over the weak covenant packages included in many bond indentures, but bond issuers often contend that the absence of certain covenants allow them greater strategic flexibility in allocating value between debt investors and shareholders.

Key Covenants Can Mitigate Bondholder Risk

From Moody's perspective, certain key covenants remain critical for bondholder protection. The covenants we consider most important address event risk and various forms of de-capitalization (i.e. leveraged buyouts, spin-offs, dividends and share re-purchases). Such covenants can usually be incorporated without hampering a company's flexibility and ability to access liquidity, if necessary. As a result, Moody's places high value on the presence of restricted- payment tests and change-of-control covenants. Academic research supports leverage tests as protection against LBOs. We place less faith, however, in various forms of negative pledge clauses, for reasons explained further below.

Prior to 1980, there was a relatively standard set of traditional protective covenants that were included in most bond indentures. Over time highly creditworthy companies began issuing debt with less restrictive covenants. In Europe this trend was also encouraged by much improved liquidity in the market following the introduction of the Euro.

Moreover, the presence of certain covenants tends to be cyclical and often lags the very concerns that they are meant to address. Several event-driven covenants emerged following the intense leveraged buyout activity of the late 1980s (e.g., poison puts). More recently, the presence of such covenants has declined and appears to be at a cyclical low. In Europe, the LBO market burgeoned post 2000, and covenant packages were modeled primarily on US experience with adjustments for local laws and restrictions. Over the period since 2000, indentures in European high yield have remained restrictive, although the leverage of the transactions has continued to rise, leading to overall concerns with regard to protection in a downside scenario.

Notably, a significant body of academic research supports the theory that, in general, a strong covenant package reduces a company's cost of debt and protects investors from wide negative swings in value. Today, many of the most highly rated issuers have a limited set of weak covenants. This is driven, in part, by the current credit cycle which has exhibited a particularly high degree of liquidity. Strong demand has created the opportunity for issuers to obtain low coupons despite weak covenant packages.

Through improvements in indenture covenants, investors can enhance investor protection from the impact of dramatic changes in risk and hence retain greater value. Academic research has shown that bonds with effective covenants have outperformed covenant-light bonds following mergers and leveraged buy outs. In addition, the magnitude of bond price losses was greater for higher rated debt and longer maturities.

Event risk and de-capitalization can be significantly constrained by legal covenant. However, indentures are often crafted, particularly at the investment-grade level, with either less than adequate covenants or with substantial enough exceptions to render them ineffective. A negative pledge, which is probably the most commonly found covenant, has not proven to be particularly effective at limiting a company's event risk given its frequently liberal allowances, including carve-outs for new bank borrowings and borrowing at the subsidiary level.

Covenants are also meant to mitigate the consequences of fundamental credit deterioration, principally the risk of subordination. Moreover, as a company's credit quality worsens, equity stakeholders and managers become more inclined (and have greater incentive) to make increasingly risky decisions. Appropriately designed covenants, such as a negative pledge clause, with very limited carve-outs and attributed to all the indebtedness of a company, can reduce those opportunities, or at least permit bondholders to evaluate whether it is advantageous to consent. Also important in this context is cross-default protection. While cross default is helpful where a bank covenant default results in the acceleration of a loan, not all bank defaults will trigger the cross default provision within a bond.

In Europe, especially with regard to fallen angels, restrictive and bondholder-protecting covenants generally only apply as long as the company has a non-investment grade rating. Most of the key covenants fall away if the company reaches investment grade status (e.g. Heidelberg Cement). Asia exhibits a similar environment where bond indentures of investment grade rated issuers have very limited covenant protection. In the U.S., which is the most highly developed market, there is a greater range of protection provided by investment grade indentures, although overall it is still relatively weak.

1. *Euro Debt Market Association ("AMT")*

Market Forces Also Undermine Covenants

Other observers have posited that the deepening of the market and the need to return for subsequent financing has reduced the prevalence of covenants. It is certainly the experience of investors today that the unusually benign credit environment and strong liquidity have made it far easier for an issuer to go to market with a very weak covenant package. Greater scrutiny of covenant packages may, of course, drive better protection. In any case, debt covenants help reduce the agency cost associated with the shareholder-creditor conflicts of interests.

Covenant- Mapping Grid

The true degree of protection offered by covenant packages in bond indentures cannot be known until tested, but it is possible to make some general observations about the strength of certain key covenants.

Their importance within a covenant package can be roughly assessed and communicated. Moody's is proposing a framework for the evaluation of the relative quality of each key covenant individually in a package and the covenant package, as a whole, assigning a score of CQ-1 through CQ-3 to the indenture.

For each covenant, Moody's has established criteria to measure the level of protection offered. These are defined as CQ-1: strong investor protection; CQ-2: good investor protection and CQ-3: weak or no investor protection. An indenture with weak or no covenants would receive a CQ-3.

	CQ-1 Strong	**CQ-2 Good**	**CQ-3 Weak**	**None**
Restricted Payments				
Change of Control				
Merger Restrictions				
Asset Sales/Conveyance Restrictions				
Limitation on Debt Incurrence				
Negative Pledge/Limitation on Liens				
Limitation on Sale/Leaseback				
Limitation on Subsidiary Debt				
Other				
Overall Assessment				

Please refer to the Covenant Quality Assessment Matrix in the Addendum for a more detailed summary of Moody's proposed guidelines for assessing each of the key covenants discussed below.

Key Indenture Covenants - <u>Event- Related Restrictions</u>

Restricted Payments

A restricted payment covenant typically restricts an issuer's ability to make distributions, whether in the form of cash, assets or securities, to shareholders, to redeem subordinated debt, repurchase equity or provide dividends. Such a covenant also constrains an issuer's ability to make "restricted investments." These are investments in "unrestricted subsidiaries" –- that is, subsidiaries not subject to the indenture covenants – as well as other investments that are not "permitted investments," such as joint ventures and minority investments.

Such a provision, if applied, should create a significant safeguard in the context of shareholder-creditor conflicts and the potential for shareholder activists to pressure management to reward shareholders at creditors' expense. The provision would also allow a further limit, in addition to the debt covenant, on the degree to which shareholders can use indebtedness of the issuer to finance distributions to shareholders in leveraged recapitalizations or buyouts.

However, it is not typical for even the most restrictive covenants, which are typically found in high yield indentures, to absolutely forbid dividends, nor is this necessarily desirable. For low growth, high cash flow companies (where bonds are no call or only callable at significant premiums), an absolute prohibition on dividends may be impractical because issuing dividends may become more rational than reinvestment.

Restricted payments covenants are typically crafted in two parts. The first is a general basket that typically builds as a percentage of consolidated net income of the issuer and its restricted subsidiaries. The second part of the covenant is a list of specific baskets for specific purposes and in specific amounts.

The General Basket

The general basket is designed to be a function of a company's profitability over the entire period since issuance of the bonds, or of some other earlier measurement date. It is cumulative and may be used for distributions subject to the absence of any pending event of default on the bonds or to the company's ability to incur an additional $1.00 of "ratio debt" (as described below).

The general basket is the sum of a number of different components: one is 50% of consolidated net income minus 100% of consolidated net losses. Where consolidated, net income does not present a fair picture of the company's performance because of significant non-cash reductions to consolidated net income; the component is sometimes replaced with a cash flow measure, such as EBITDA minus 150% of consolidated interest expense.

Other typical components of the general basket are the following (in each case, since the measurement date): (a) equity contributions; (b) conversions of debt into common equity; (c) the value or amount of investments in an entity that had been previously designated as an unrestricted subsidiary, but that has been re-designated as a restricted subsidiary; and (d) the amount received since the measurement date from dispositions of other restricted investments that are not "permitted investments".

Common specific baskets include:

- The payment of dividends to shareholders within 60 days of their declaration, as long they were permitted when declared
- Redemptions of subordinated debt or equity made in exchange for, or out of the proceeds of, the sale of equity (other than "disqualified stock")
- Redemptions of subordinated debt using the proceeds of permitted refinancing debt
- Distributions to a parent to pay corporate overhead and income taxes arising from the operations of the issuer and its restricted subsidiaries
- A general basket in a specified amount; and, as long as there is no default or event of default
- Sometimes, the purchase of subordinated debt out of asset sale proceeds after any required offer to purchase the bonds that are the subject of the indenture has been made
- A basket for employee stock repurchases
- Sometimes dividends, as long as they are included in the definition of consolidated fixed charges for purpose of the ratio debt incurrence test
- Stock repurchases upon the exercise of stock options (that is, the stock forfeited to pay the option price)
- Distributions to permit specified payments on parent bonds, sometimes as long as $1.00 of additional ratio debt could be incurred.

The definition of a "restricted payment" should include all of the items enumerated above, without ignoring one of the categories. In evaluating the definition of a restricted payment, it is also important to review any component definitions, such as the definition of a "permitted investment".

In addition, it is vital to evaluate how the general basket is calculated. Several typical considerations in this process are:

- What percentage of consolidated net income is permitted to be distributed?
- Are there any unusual "add backs" used in calculating consolidated net income, such as extraordinary cash losses?
- Is the test calculated using a standard other than consolidated net income, such as EBITDA -- where the adjustments may be greater and thus potentially provide management with more discretion?
- Is the measurement date for building the general basket the same date as the starting point for reductions of the general basket through use?

Other noteworthy points to consider when reviewing the specific baskets:

- How much can the specific baskets add up to on an aggregate basis?
- Permitted cash dividends to be made at a time -- as long as such dividends are part of the ratio test (the debt incurrence test is not restrictive if no ratio debt is being incurred).
- What conditions surround distributions to pay amounts due on parent bonds?
- What payments are permitted? The range is from interest only, to scheduled principal payment, to all required payments, including on acceleration.

Where an asset sale covenant permits a high level of asset sale proceeds to be received without reinvestment, it is important to consider where subordinated debt payments are permitted to be made out of all proceeds as long as the covenant is satisfied. In other words, proceeds may never have been required to be offered to bondholders, but they may still be permitted to be used to redeem subordinated debt.

In most cases, Moody's is comfortable with fixed charge coverage of at least two times and not to exceed 50% of consolidated net income with limited baskets and carve-outs. We are also sensitive to the extent that such a calculation provides material opportunity to effect a transaction over the near term.

Change of Control

A change of control covenant is designed to protect bondholders most directly from leveraged buyouts as well as from other situations where a change in ownership could damage credit quality. The covenant generally gives bondholders the opportunity to put their bonds back to the issuer prior to a change at 101% of the principal amount. This commonly applies following a transaction that affects all, or substantially all, of the company and its restricted subsidiaries.

Moody's looks at three variables when measuring the quality of the change of control covenant: (1) percentage of voting rights required, (2) board replacement, and (3) rating triggers. In sponsored transactions, it is important to define a "permitted holder" that can acquire a controlling position without triggering a change-of-control put. The definition should be limited to the actual sponsor group, not any existing shareholder, and it should require control of the requisite percentage by the sponsor, not just membership in the group by the sponsor. For all transactions, it is important to note the specific percentage that triggers change of control. Permitted holders definitions, if drawn too broadly, do not offer sufficient protection.

In certain cases and frequently in Europe, a change of control clause is only triggered if, at the same time, or shortly after a change of control event occurs, the rating of the company is downgraded to sub-investment grade. As a rating action can happen, before the legal change of control occurs, this could lead to investors being unprotected. In Moody's view, protection is clearly enhanced by a covenant that includes the right to put the bonds over a period which includes 90 days before to 90 days after notice.

Restrictions on Mergers/ Sales of All or Most Assets

Merger restrictions intend to limit an issuer's ability to substantially merge or consolidate with another corporation, or for the issuer to convey all (or substantially all) of its assets in one or more related transactions. Currently, this covenant rarely offers significant protection because of large carve-outs and important exceptions. The prohibition usually does not apply if the surviving corporation assumes the debt, and there is no immediate event of default. Other limitations of this covenant include uncertainty about when a sale of all (or substantially all) assets has occurred. While the actual percentage that equals "substantially all" is subjective it has been addressed in case law and can be triggered at less than, for example, 90%, but it is not an explicit amount or percent (and is likely to be greater than 50%).

For purposes of the covenant, the threshold for this test is likely to be high. In fact, sequential, unrelated sales that, in aggregate, amount to substantially all assets, will not trigger a default or a requirement that the bonds be assumed. Moreover, provisions that permit a transaction if one of a number of alternative tests are satisfied, such as a ratings trigger, or an ability to satisfy ratio-debt incurrence test, or a fixed charge coverage ratio is not worsened, or net worth is not impaired are also not particularly bondholder friendly.

The ambiguous terminology frequently employed in indenture documents can be dangerous. For instance, it allowed First Data Corp to proceed with its plan to spin off its Western Union subsidiary, a significant source of cash flow (about 50% of the First Data's overall cash flow) and hence credit strength for First Data, without a clear requirement for debt transference or reduction. Western Union could be spun off because it was not specifically deemed to be "substantially as an entirety".

Essentially, Moody's view of very good protection assumes pro forma fixed charge coverage at or better than prior to the merger and the ability of the combined company to borrow another $1 of debt under the debt incurrence test.

Key Indenture Covenants - Limitations on Subsequent Financing

Negative Pledge/Limitation on Liens

A negative pledge covenant, if effective, prevents the issuer from raising secured debt unless it provides security “ratably”, thereby limiting subordination. Similarly, a limitation on liens operates like a negative pledge clause: it is meant to constrain a company’s ability to create secured debt ahead of the existing security. Many indentures include exceptions, and reflect small transactions that are done during the ordinary course of business (vendor financing, real estate mortgages, etc.). Mainly in Europe, the negative pledge clause only refers to “traded debt” which substantially limits bondholder protection. Moreover, although a negative pledge establishes the sharing of collateral (in bankruptcy), asset sales that diminish the collateral pool, prior to bankruptcy, are not necessarily prevented.

There are exceptions (mortgages for property, purchase money interest, etc). These may have been designed to relieve impediments to the normal course of business, but they may, under certain circumstances, allow for more aggressive leverage. A negative pledge may also include a basket for secured debt and sale/leaseback arrangements that should not exceed a modest percentage of consolidated net tangible assets.

Liens definitions that do not include debt are of little value. This was recently made evident in Computer Sciences Corp.’s indenture, which has become of greater interest to investors following the company’s recent announcement that it is exploring strategic alternatives including a potential company sale. The indenture defines a lien as "any lien, security interest, charge, mortgage, pledge or other encumbrance of any kind including any conditional sale or other title retention agreement, any lease in the nature thereof, and any agreement to give any security interest **other than an agreement to secure Indebtedness equally and ratably upon the incurrence of other secured Indebtedness**.”

Liens that are only attributed to real property do not address the opportunity to lever intangibles in certain sectors. This oversight was made apparent in the case of SunGard Data Systems, where collateral defined as “intangible assets” was considered very attractive (such as patents) and ultimately a distinction within the company’s capital structure following the opportunity to execute a leveraged buy out of the company. (For more details, please refer to the examples in the addendum.)

Conveyance of Assets Restrictions

Restrictions on asset conveyance should limit an issuer’s ability to sell an asset without using the proceeds to reduce debt or re-invest in the remaining operations, explicitly fixed assets. If such a provision is not included, we view a limitation on the aggregate amount of assets that can be conveyed as protective, although less so.

Reinvestment provisions should require that proceeds be reinvested in other fixed assets, not merely reinvested in the business. Typically, a certain percentage of the asset sale proceeds is required to be in cash – generally 75%. For secured bonds, proceeds of sales of collateral pending reinvestment would be held in a collateral account in a more restrictive indenture.

In Moody’s view, debt permitted to be a reduction to net proceeds, or permitted to be paid in preference to the bonds, should be limited to debt secured by the assets sold, debt of the applicable restricted subsidiary that sold the asset that is senior to, not pari passu with, the bonds or any guaranteed and specified senior debt.

We note that less protective bonds contain minimum baskets before the covenant applies - with less restrictive formulations permitting dispositions of some percentage of tangible net assets. Other carve-outs from the defined term “asset disposition”/”asset sale” to which the covenant applies could also weaken protection. Asset sale proceeds applied to senior bank debt should permanently reduce the basket for such debt.

Limitation on Debt Incurrence

Limitations on debt are meant to restrict the total claims on a company. They have provided greater protection in regard to leveraged buyouts than have other financial covenants such as negative pledge, for example. How debt is defined, however, will impact the value of this covenant – debt can be specified as total debt, or can be considered a weaker version of only senior obligations, or debt with maturities beyond one year.

The debt incurrence covenant is typically crafted in two parts. The first is a test that permits the incurrence of debt so long as a specified financial ratio is satisfied after giving a pro forma effect to the occurrence. The most common ratio is a consolidated fixed-charge coverage ratio (defined as the ratio of EBITDA to interest expense and, sometimes, cash dividends). Leverage ratio tests are also used (e.g. debt/EBITDA).

The second part of the covenant permits the incurrence of debt specified in a series of baskets, without regard to the incurrence test Typically included are:

a A specified basket for senior bank debt
b Guarantees by the issuer and its restricted subsidiaries of indebtedness, incurred in compliance with the indenture
c Intercompany indebtedness between the issuer and its restricted subsidiaries
d Indebtedness of a restricted subsidiary in existence when the subsidiary was acquired and not incurred in contemplation of the acquisition (where $1.00 of ratio debt could have been incurred following such acquisition)
e Refinancing indebtedness that does not enhance the structural or contractual seniority of the debt being refinanced
f A specified basket for capitalized leases and purchase money debt; a general basket in a specified amount
g Liabilities not in the nature of debt for borrowed money, such as purchase price adjustments and indemnities, hedging exposure in the ordinary course, workers compensation liabilities, bank overdrafts, etc

The strength of this covenant is a function of two factors: (1) the aggregate amount of debt that can be issued and (2) whether all types of debt are included in the definitions. A limitation on debt at the subsidiary level should add value to the covenant protection.

Moody's also notes that the ratio debt is typically limited to debt incurred by the issuer and guarantor restricted subsidiaries -- that is, to debt incurred at the same structural level as the bonds. The issuer thus has discretion in how to classify debt when incurred, and the ability to re-classify debt from time to time to create additional flexibility is less restricted. Moody's analysis evaluates the aggregate size of baskets and also how leverage can be added without the need to comply with the ratio.

In calculation of the ratio debt, we are skeptical of add-backs to consolidated EBITDA for unusual items, and whether or not, for acquisitions and divestitures, management is permitted to pro forma anticipated cost savings for purposes of the calculated EBITDA.

Moody's would expect to see a debt-to-EBTIDA or a fixed charge test with only modest carve-outs and tight definitions in order to be comfortable with the covenant. We also look for a limited ability to raise senior debt and are sensitive to the extent that the calculation provides material opportunity to effect a transaction over the near term.

Limitation on Sale/Leaseback

Limitation on sale/leaseback restricts the issuer from selling assets (or removing them from the balance sheet for accounting) and then leasing them. Such a shift creates a debt burden in the form of leases, as well as increasing fixed charges and reducing the asset pool available to bondholders. We often see sale/leaseback transactions when a company is in need of liquidity.

An ideal covenant should require the reinvestment of any funds from an asset sale into a new asset or debt reduction. In the event that debt repayment is not required, a limitation on the sale/leaseback to less than 10% of consolidated stockholders equity offers good protection.

Carve-outs often include transactions of less than three years and if the transaction does not violate the negative-pledge clause basket.

Limitation on Subsidiary Debt

The limitation on subsidiary debt is relevant in the absence of upstream guarantees and is an important constraint on consolidated leverage and subordination. In Moody's view, there should be no borrowing at the subsidiary level unless it is permitted ratio debt.

Other Considerations

Not to be neglected are the benefits derived from guarantees by all key subsidiaries. These guarantees exist in order to prevent transactions at a holding company or subsidiary that could damage the overall creditworthiness of the issuer, and thus hinder full access by the bondholder. Further protection is often achieved with a cross-default provision and restrictions on related party transactions.

Importantly, covenants that include a provision that permits the suspension of the covenant upon receiving an investment grade rating are viewed quite negatively.

Addendum - Current Examples

Effective Protection

Ashland

Time Warner

Legrand

Value Deterioration

SunGard

First Data

Viacom

TDC

Last Minute Changes

BAA

Ashland

In June 2005, Ashland Inc. sold its 38% interest in Marathon Ashland Petroleum (MAP), a refining and marketing joint venture, as well as certain other businesses, to its JV partner, Marathon Oil Corporation, in a transaction valued at about $4.5 billion. Upon closing, through a series of mergers, all of Ashland's existing businesses, except for its interest in MAP and the other assets to be sold to Marathon, were transferred to a successor to Ashland ("new" Ashland), a publicly traded company owned by Ashland shareholders.

Following Ashland's announcement of the transaction in March 2004, Moody's placed Ashland's ratings under review for possible downgrade. Moody's then signaled to the market that a downgrade in Ashland's Baa2 senior unsecured debt rating to non-investment grade was possible if Ashland were to sell its interest in MAP.

Structured to be generally tax-free to Ashland shareholders and tax-efficient to Ashland, the transaction required the consent of holders of at least 66 2/3% of Ashland's notes and debentures. Covenants restricting consolidations, mergers, asset conveyance, and sale/leasebacks in Ashland's indentures would have prevented the company from completing the transaction as contemplated.

Consequently, prior to closing, Ashland launched cash- tender offers and consent solicitations, whereby it offered to purchase for cash any and all of its outstanding notes and debentures in exchange for consents from holders to eliminate or modify substantially all of the restrictive covenants, certain events of default, and additional covenants and rights in the related indentures.

The company received consents representing approximately 98.7% of the aggregate principal amount of the notes and debentures affected. The total cash consideration for validly tendered notes composed a "fixed price spread," plus a consent payment that resulted in full repayment of principal.

Moody's subsequently downgraded the non-tendered notes and debentures from Baa2 to Ba1. It is clear that in this case, indenture covenants offered strong protection to bondholders.

It should be noted that the limitation on asset conveyance covenant was not specific in defining what portion of assets would be deemed a transfer of assets substantially as an entirety. In this case, the company chose the most conservative legal interpretation of this covenant, which ultimately protected bondholders. However, in other situations, a vaguely defined asset conveyance covenant might be insufficient to prevent substantial de-capitalization.

SunGard

On August 11, 2005, a consortium of private equity investors consummated an $11 billion acquisition of SunGard Data Systems, Inc., resulting in significant changes to the company's capital structure. The purchase was financed by new borrowings of approximately $7 billion under a new senior secured credit facility, a new receivables facility, a new revolving credit facility, and new unsecured notes and senior subordinated notes. Structural and covenant implications arising from the transaction are discussed below.

Structural Considerations:

As a direct result of the transaction, Moody's downgraded SunGard's existing $500 million of senior unsecured (now secured) notes, which were not part of the transaction financing package, to B2 from Baa3, reflecting the company's significantly increased debt leverage and the granting of a more valuable security interest in the company's intangible assets (and the ensuing effective subordination for existing stub noteholders to the new secured lenders with respect to these assets or, more appropriately, "deemed value").

The collateral package for the existing notes consists of tangible assets as well as the capital stock of subsidiaries. In contrast, the collateral package for the company's new bank facilities (part of the transaction financing package) consists of the same collateral securing the existing notes, as well as a majority of the company's intangible assets. In Moody's opinion, SunGard's intangible assets have value on a going concern basis and provide a technical advantage to the collateral package covering the new credit facility.

The agreements that underline SunGard's credit facilities and debt indentures include a number of significant covenants that merit discussion as a means of informing one's investment decision.

Key Indenture Covenants:

SunGard's bond indenture covenants appear relatively standard and customary for the sector and are consistent with the company's peer group. Like other technology companies, SunGard's indentures for its new unsecured senior notes and senior subordinated notes contain several key covenants that limit the company's ability to incur additional indebtedness and make restricted payments.

As is typical of investment grade indentures, however, the indenture for the company's existing notes dated January 15, 2004 (when it still enjoyed investment grade ratings, prior to the announced LBO) has no covenants limiting restricted payments or debt incurrence. Per the existing note indenture's limitation on liens covenant, however, existing noteholders are entitled to be ratably secured by any lien on principal property (notably excluding intangible property, though), the stock of subsidiaries, or the debt of a subsidiary.

Such provisions are also typical of investment grade indentures. The distinction with respect to tangible versus intangible assets is an important one in the case of SunGard -- again because Moody's perceives real value in the company's intangible assets even in a distress scenario, and as such, this factor is been reflected in our ratings.

Viacom Inc. and Time Warner - A Media Story

The following illustrates the multiple options that bondholders can press for and issuers can provide - options that mitigate or eliminate significant discretionary event risk without necessarily limiting liquidity or financial flexibility.

Viacom Inc.

In January 2005, the then CEO and current controlling shareholder of Viacom Inc. publicly and unexpectedly communicated that the company was going to "re-evaluate" its pledged commitment to its credit ratings. The ratings were placed on review for downgrade, and bond spreads widened considerably. In this case, the cause was a malaise surrounding media industry stocks resulting in pressure from institutional investors to get higher returns through debt financed shareholder friendly changes in financial policy.

Over the five and 1/2 years prior to the re-evaluation, bond spreads improved consistently over the years with the improved credit profile of the company, and ultimately, the controlling shareholder, the board of directors, and senior management achieved, and then pledged to maintain, an A3 rating within very specific credit metrics. At one time, the company had bank and public debt at an intermediate subsidiary (Viacom International). As a result the company placed an upstream guarantee from the subsidiary to assure that senior unsecured lenders and bondholders at the parent and the subsidiary levels were pari passu. Over time, as the Viacom International debt matured, or was otherwise retired, these guarantees no longer functioned to reduce structural subordination.

As a result of the re-evaluation, the company decided to split itself into two publicly traded companies at year end 2005 by spinning off the company's cable network, filmed entertainment and music publishing businesses and related assets along with the floating rate debt and some other liabilities, into a new company (New Viacom Corp., renamed Viacom Inc.), and leaving the balance of the operations along with the existing rated debt, and significant pension and asbestos liabilities with CBS Corporation (formerly Viacom Inc.) In October 2005, in anticipation of this split as well as expectations of weaker credit metrics, Moody's downgraded the company (now CBS Corporation) by three credit notches from A3 to Baa3.

The company eventually decided to --

- Increase leverage to buy back considerably more stock than its free cash flow could support, thereby using up financial capacity
- Split into two public companies along content and distribution lines
- Maintain its existing dividend payout at the new CBS Corporation which represented a larger percentage of operating cash flow at CBS, in lieu of a share repurchase program.

The company was able to accomplish all of this without permission from bond holders, and without any additional compensation for the higher risk they now face (although older bonds did benefit from the substantial up-tick in the company's credit profile when the CBS/Viacom merger transaction occurred.)

The reason is that there weren't any financial covenants limiting leverage, the negative pledge restricting disposition of assets was ineffective (limited the disposition of "all or substantially all" assets) and was not tripped therefore allowing the company to move assets despite the existence of guarantees (guarantees are only as strong as the restrictions on asset dispositions), and there was no "make whole" provisions or yield-resets for higher credit risk for non-fundamental discretionary changes in credit risk policy.

Time Warner Inc./Time Warner Cable:

Time Warner Inc. faced pressure from institutional shareholders, and particularly from a group led by Carl Icahn, also due to lackluster share performance. The Time Warner group has two discreet legal issuer groups, Time Warner Inc. (Baa2) and its subsidiaries (excluding Time Warner Cable), and Time Warner Cable standalone (Baa2) and its subsidiaries, each with their own ratings (which could diverge), and a differing story on bondholder protections.

Time Warner Inc.'s rated debt consists of debt issued at the ultimate holding company and issuer of all new debt, Time Warner Inc. It also consists of debt at former issuers of debt, including Turner Broadcasting System (TBS), which issued debt before being acquired and merged with the company, and debt issued by the former holding companies before the TBS acquisition, now called Time Warner Companies, and before the AOL merger, now called Historic TW.

Management of the company wished to maintain an investment-grade profile, including legal recourse simplicity, and the benefit of diversity of its businesses, so in 2001 it put in place cross-guarantees to unify the credits. Therefore, all these debt issuers maintain the same ratings. In addition, in some legacy debt indentures, the company agreed to a negative covenant prohibiting disposition of substantially all of its assets, though it didn't define "substantially".

Time Warner Cable (TWC) is a 84% owned subsidiary of Time Warner Inc. and it is the parent company for Time Warner Entertainment Company, L.P. (TWE)(Baa2). It is an encumbered holding company, and it has unencumbered operating subsidiaries. TWE holds all of TWC's public debt while TWC holds the company's bank debt. Time Warner Cable, Time Warner NY Cable, a subsidiary of TWC, and TWE effectively cross-guarantee each other, thereby unifying the credit in the same manner as Time Warner Inc. does.

However, under Icahn's failed plan for the group, a striking difference in bondholder protections was apparent. The plan included separating Time Warner into four separate public companies, three of which would make up Time Warner Inc., and the fourth would essentially consist of TWC. This meant leveraging all of them up and facing the possibility of losing their investment grade ratings.

The TWC bondholders have minimal financial covenants limiting additional leverage, and they have no change of control provision to give bondholders the option of putting back their bonds if Time Warner Inc. no longer owns the company. Essentially, they had almost no protection.

The Time Warner Inc. bondholders, including those of its subs, TBS, Historic TW, and Time Warner Companies as well, could actually have faired much better. The "substantially all" negative pledge, could be within the gray area as potentially two-thirds or more of the assets (on an EBITDA basis) could be spun off under the plan. Also, and perhaps more importantly, AOL has an upstream guarantee from its operations (unlike the Viacom situation) which would also effectively back the AOL cross-guarantee; TBS has some operating assets within it (not just an intermediate hold company), also giving more teeth to the cross guarantees.

In order to break up the companies the way Icahn envisioned, he would likely have needed to provide make whole payments to bondholders, effectively paying them for the additional risks, and they could have chosen to sell the bonds if they wished without the same potential loss as TWC or Viacom bondholders faced.

Legrand

In 2002, Kohlberg Kravis Roberts & Co Ltd. (KKR), together with Wendel Investissement, announced the acquisition of Legrand SA (today called Legrand France) in one of the largest LBO transactions seen in Continental Europe at that time. Total consideration was about EUR 4.6 billion, thereby adding around EUR 2.7 billion of additional debt to the company's balance sheet (EUR 1.8 billion after taking into consideration existing debt).

Approximately 400 million of US dollar denominated bonds ("Yankee bonds") issued in 1995 at Legrand SA remained outstanding in the new LBO structure. These obligations of Legrand SA became effectively subordinated to the Senior Credit Facility issued at Legrand SAS (which was merged with Legrand Holding (today Legrand SA) at the time of the IPO) and at the level of Legrand SA's operating subsidiaries. The Senior Credit Facility amounted to approximately EUR 2.1 billion. Both instruments were, however, structurally senior to the unsecured Senior Notes (EUR 600 million) issued by the holding company, Legrand Holding SA (today called Legrand SA).

In this case, protections for holders of Yankee bonds during Legrand's acquisition were considered by Moody's to be comparatively weak. The Yankee bonds' covenants allowed the change in ownership, material additional debt to be incurred and for the bonds to become subordinated to new debt. While the bond included a put, this applied only in the event of a hostile take-over. Bondholders had no capacity to exercise their put option as the acquisition was recommended by the company's management.

The Yankee bonds were also governed by an indenture containing a springing lien on net fixed assets. The springing lien, however, was subject to a carve-out which allowed the higher leverage and minimized the potential net fixed assets available to the holders as collateral. As a result, the instrument remained unsecured throughout its life due to the size of the carve-out.

By the time of the transaction, Moody's had downgraded the senior debt rating of Legrand to Ba2 from Baa1 based on the significantly increased leverage of the group. In January 2003, the rating of the Yankee bond was further downgraded to Ba3 from Ba2, in part because of structural subordination. Legrand now holds a Baa3 corporate family rating with a positive outlook.

TDC

In December 2005, the Danish telecom company TDC was subject to a ca. EUR 13 billion takeover by a consortium comprising five private-equity companies. EUR 10 billion of the acquisition amount (including refinancing of existing debt) was to be financed by bank debt, thus increasing the company's net debt from EUR 2.2 billion to EUR 10 billion. In Ocotber, Moody's had placed the Baa1 ratings on review for possible downgrade following confirmation by the company that non-binding indications of interest had been received and Moody's expectation at the time that an acquisition by a financial buyer would be the most likely outcome. The bond indentures in place did not provide any covenant protection, such as change of control, and the negative pledge applied to trade debt. It allowed for a senior-secured acquisition financing, thus weakening the position of the bondholders.

In anticipation of deterioration in credit metrics, Moody's downgraded the senior unsecured bond rating from Baa1 to Ba1. As the tenor of some of the bonds was shorter than the tenor of the bank loans, Moody's believes that the company decided to buy back these bonds, although it was not required by the indenture.

BAA

At the beginning of February 2006, BAA issued three series of Notes under its Euro Medium Term Note Programme, totaling approximately GBP 2 billion. At the time of launch, the terms and conditions of the Notes did not include any change of control protection for note-holders.

Subsequent to the launch of the Notes, a Spanish construction company, Grupo Ferrovial S.A. (unrated) announced that it was considering forming a consortium to make a cash offer for all of the share capital of BAA. After this event, BAA entered into discussions with the Association of British Insurers, a body representing the interests of institutional investors based in the UK, the result of which was a change to the terms and conditions of the relevant series of Notes. The changed terms now incorporate a Change of Control clause, allowing note-holders to sell their Notes back to BAA at face value if a takeover results, within 90 days of such takeover taking place, in a deterioration of the ratings of the relevant series of Notes to non-investment grade status, provided that an independent financial advisor has certified that such takeover will be or is materially prejudicial to the interests of the note-holders.

The terms and conditions of four other outstanding series bonds issued by BAA (long-dated bonds 2016, 2021, 2028 and 2031) contain both an interest cover covenant (average ratio of Group EBIT to Group interest payable to be maintained at not less than a ratio of 2:1 on average over a rolling three years) and a gearing ratio covenant (net borrowings shall not exceed at any time an amount equal to 175% adjusted capital and reserves), which could be said to provide some restriction on the incurrence and management of potential acquisition debt in the immediate future.

Covenant Quality Assessment Matrix

Highest ← → Lowest

	CQ-1	CQ-2	CQ-3	None
Restricted Payments	LTM fixed charge coverage ratio test at least 2.0 times and not to exceed 50% consolidated net income or EBITDA less 150% interest expense; all restricted payments and fixed charges covered by definition; carve-outs are less than 2% of total assets; headroom under LTM fixed charge coverage is less than 0.5 times	LTM fixed charge coverage ratio test at least 2.0 times and/or not to exceed 50% consolidated net income; carve-outs are equal to or greater than 2% of total assets; all restricted payments and fixed charges covered by definition; headroom under fixed charge coverage is less than 2.0 times	Significant headroom under ratio test	Covenant not present
Change of Control	Cash put option @ 101 or better if change of control, defined as acquisition of 50% or more of voting rights, or Board replacement	Cash put option @ 101 or better if change of control, defined as acquisition of 50% or more of voting rights, or Board replacement, and rating downgrade to non-IG within 90 days before or after public notice or change of control	Cash put option @ 101 or better if change of control, defined as acquisition of 50% or more of voting rights, or Board replacement, and rating downgrade to non-IG within 90 days after change of control	Covenant not present
Merger Restrictions	Pro forma fixed charge coverage covenant of successor company represents 100%+ of predecessor company and can incur another $1 of debt under the debt incurrence test	Pro forma fixed charge coverage covenant of successor company represents 100%+ of predecessor company or can incur another $1 of debt under the debt incurrence test	No merger unless liabilities assumed by surviving entity	Covenant not present
Asset Sales/Conveyance	100% applied to debt reduction or reinvested in fixed assets within 12 months; at least 75% of proceeds in cash or marketable securities	100% applied to debt reduction or reinvested in fixed assets or asset acquisitions within 12 to 24 months; at least 50% of proceeds in cash	100% applied to debt reduction, or reinvested in business; or less than 50% cash proceeds required; or no limitation on asset sales unless debt assumed by acquirer	Covenant not present
Limitation on Debt Incurrence	Pro forma LTM Debt/EBITDA and/or fixed charge coverage test, tight definitions, and carve-outs < 2% of total consolidated assets; headroom under Debt/EBITDA and/or fixed charge coverage test is less than 0.5 times	Pro forma Debt/EBITDA or fixed charge coverage test, loose definitions but carve-outs < 2% of total consolidated assets; headroom under Debt/EBITDA test is less than 1.0 times, or under fixed charge coverage test is less than 2.0 times	Pro forma Debt/EBITDA or fixed charge coverage test, loose definitions, carve-outs > 2% of total consolidated assets; headroom under LTM Debt/EBITDA test is greater than 1.0 times, or under fixed charge coverage test is greater than 2.0 times	Covenant not present
Negative Pledge/Limitation on Liens (applies only to Senior Notes)	Permitted only if equally and ratably secured and guaranteed, no carve-outs, and if limited headroom under debt incurrence test	Less than 15% of net tangible assets or tangible net worth and carve-outs limited to working capital or a leverage based calculation, or if equally and ratably secured and guaranteed	Greater than or equal to 15% of net tangible assets or tangible net worth with large carve-outs	Covenant not present
Limitation on Sale/Leaseback	100% applied to debt reduction within 12 months	For other than ordinary course of business, aggregate sale leaseback does not exceed 10% of Consolidated Stockholders Equity unless fixed asset re-investment within 12 to 24 months	For other than ordinary course of business, aggregate sale leaseback exceeds 10% of Consolidated Stockholders Equity; or long time frame for re-investment of proceeds	Covenant not present
Limitation on Subsidiary Borrowings	No borrowings by non-guarantor subsidiary debt	Borrowings by non-guarantor subsidiaries permitted under ratio debt	Borrowings by non-guarantor subsidiaries permitted under ratio debt, but significant headroom	Covenant not present

Related Research

Rating Methodology:

Moody's Approach Toward The Analysis Of Indenture Covenants, October 1999 (49130)

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