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חומר בינלאומי

נספח ה-1:

מאמר הדן במסלול "נאמן על"

AN INSTITUTIONAL INNOVATION TO REDUCE THE AGENCY COSTS OF PUBLIC CORPORATE BONDS

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Debt financing by a corporation gives rise to conflicts of interest between creditors and stockholders that can reduce the value of the firm. Such conflicts are limited more effectively in private loans extended by banks and institutional lenders than in publicly traded bonds. However, public debt has advantages not shared by private debt: notably, greater liquidity and diversifiability.

In this paper, we propose an institutional innovation—the "supertrustee"--that is designed to incorporate some of the most valuable aspects of private debt into public debt. The supertrustee would be charged with responsibility to monitor compliance with bond covenants and given exclusive authority to negotiate amendments and to decide what action to take in the event of a breach. The goal is to facilitate relatively inexpensive and non-opportunistic renegotiation and enforcement of bond covenants—a

goal made difficult by the dispersion and fluidity of bond ownership--thus enabling public debt to have more and tighter covenants that better control the behavior of the firm without requiring that the firm sacrifice strategic flexibility. Our proposal holds out the promise of controlling the agency costs of public debt in the same way those costs are reduced in private lending, but without impairing liquidity or diversifiability.

As we argue below, the proposed structure is likely to be most valuable in cases of debt issued by firms with greater inherent credit risk and in more volatile industries with significant intangible assets. The scheme will also be more attractive for larger, longer-term issues because most of the costs of a supertrustee are fixed and because covenant protection and the ability to renegotiate covenants are both more valuable on longer term debt.

I. THE AGENCY COSTS OF DEBT AND DIFFERENCES BETWEEN PRIVATE AND PUBLIC DEBT

II.

Corporate directors and executive officers, even when acting in the best interests of shareholders to maximize stock prices, sometimes undertake initiatives that reduce the value of a firm's bonds and even the aggregate value of the firm.[1] For example, if the firm is very highly leveraged, managers may choose high-variance projects with negative NPVs because the high variance has the effect of transferring wealth from bondholders to stockholders. Many executives of U.S. savings and loans opted for such a high-risk investment strategy during the early 1980s, when high interest rates raised their effective leverage rates to 100% (or, in many cases, even higher). Management can also reduce the

[1] For the seminal discussion of shareholder-bondholder conflicts, see Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure," *Journal of*

value of outstanding bonds by issuing additional debt, or by distributing corporate assets to shareholders that could otherwise be used to service debt.[2]

Creditors protect themselves against the prospect of wealth transfers to stockholders with a variety of devices. Perhaps most effective, by limiting the maturity of a loan, creditors reserve the right to renegotiate the terms of the loan in response to changes in the firm.[3] However, short maturities may be unattractive to both lenders that need to fund long-dated liabilities and to companies financing the purchase of long-lived capital assets. Also, long term debt saves the issuance costs of frequent rollover financing.

Creditor interests can also be protected with loan covenants that restrict the actions of the firm or specify minimum operating characteristics whose breach accelerates a loan's maturity.[4] But covenants have costs as well as benefits. They may prevent the firm from undertaking value-increasing projects. Or management may inadvertently breach a covenant (such as a specified financial ratio), thereby triggering acceleration of

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Financial Economics, 1976, 305-360.

[2]See, for example, the leveraged recapitalizations and special dividend payments of Colt Industries (Wall Street Journal, July 21, 1986 and July 24, 1986) and Quantum Chemical (Wall Street Journal, December 29, 1988) and the spin off of Marriott International by Marriott Corporation as originally proposed in 1992 (Wall Street Journal, October 6, 1992).

[3] Carey, M., S. Prowse, J. Rea and G. Udell, "The Economics of Private Placements: A New Look," *Financial Markets, Institutions & Instruments,* August 1993, 40 - 41 and 45.

[4] For a more detailed examination of these sources of shareholder/debtholder conflict, see Clifford W. Smith and Jerold B. Warner, "On Financial Contracting: An Analysis of Bond Covenants," *Journal of Financial Economics*, 7, 1979, 117-161. See also A. Kalay., "Stockholder-Bondholder Conflict and Dividend Constraints," *Journal of Financial Economics* July 1982, 211-233; R. Landau, *Corporate Trust Administration and Management*, 4th ed., Columbia University Press, 1992; M. Kahan, and B. Tuckman, "Private versus Public Lending: Evidence from Covenants," in *The Yearbook of Fixed Income Investing*, J. Finnerty and M. Fridson, eds., Irwin Professional Publishing, 1995; G. Triantis, and R. Daniels, "The Role of Debt in Interactive Corporate Governance," *California Law Review*, 1995, 1073 - 1113. Typical covenants include constraints on dividend payments and the assumption of additional indebtedness, requirements for minimum liquidity and interest coverage ratios, and (more rarely) explicit constraints on asset sales, cash acquisitions and restructuring.

maturity and possibly putting the firm into financial distress.[5] And, apart from these potential problems, tight restrictive covenants and stringent minimum operating characteristics do not eliminate the creditor-shareholder conflicts that result in agency costs they just reduce them.

In many cases, the joint interests of the firm's creditors and shareholders can be best served with numerous, tight covenants that can be waived or renegotiated as the occasion demands.[6] Thus, for example, higher-risk investment opportunities that would benefit the firm as a whole do not have to be bypassed if managers can negotiate compensatory payments to creditors. Similarly, the firm can avoid costly bankruptcies if creditors can temporarily waive breaches of minimum operating characteristics.[7]

But encumbering public debt contracts with many and tight covenants, with the intention of renegotiating them should the need arise, has two problems. First, renegotiation of public bond covenants is costly when bondholdings are fluid and bondholders are dispersed.[8] Changes in covenants require a vote by the bondholders, which is time-consuming and expensive to administer. Moreover, individual bondholders have little incentive to acquire information and to negotiate with the issuer over the terms of a covenant waiver or amendment. In ordinary circumstances, there is also no committee or agent to represent bondholders in negotiations with the issuer. Given these

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[5] See also C. Smith and J. Warner, "On Financial Contracting," *Journal of Financial Economics* June 1979, 117-161.
[6] On the process and consequences of changes in bond indentures, see Kahan and Tuckman *Op. Cit.* See also Carey et. al. *Op. cit.* p. 36 and 42 and Smith and Warner *Op. Cit.* at 130.
[7] The creditors' right to decline to renew the waiver provides protection against acts that would transfer wealth from creditors to stockholders.
[8] See Carey et. al *Op. cit.* p. 39 and 44, Landau *Op. cit.* p. 139 and Kahan and Tuckman *Op. cit.*

costs and difficulties, renegotiation of the terms of publicly traded debt is generally not practicable.

Second, a borrowing firm may be concerned that its bondholders will act opportunistically should it request a covenant amendment. For example, if interest rates have increased substantially since the bonds were issued, bondholders may refuse to waive a breach of a minimum operating characteristic in order to force redemption of the bonds at par. Or they may demand compensation for agreeing to a covenant amendment that far exceeds the uncompensated cost of the amendment.[9] The fluidity of ownership of public bonds accounts for the possibility of such opportunistic behavior: bondholders do not care about their reputation; issuers have very little control over the identity of their public creditors, and so creditor reputation has limited effect on future transactions.

For all of the foregoing reasons, public corporate bonds typically have few and loose covenants. And, since public bondholders have limited protection against corporate initiatives that would transfer wealth to shareholders, they demand higher yields to compensate for prospective losses in value. The limited reduction of the agency costs of debt thus translates directly into a higher cost of credit and a reduction in the scale and value of the firm's investments.

Agency costs of debt are controlled more effectively in bank debt and privately placed loans, where ownership is neither fluid nor dispersed. Single-lender bank loans have more and tighter covenants than publicly traded bonds precisely *because* their provisions can be renegotiated and waived relatively easily, and because the borrower

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[9] See, for example, the prolonged struggle of Burlington Northern to amend covenants on public bonds issued in 1896 (Wall Street Journal, May 20, 1987, Rievman vs. Burlington Northern, 618 F.Supp. 592 (SDNY, 1985), 644 F.Supp. 168 (SDNY, 1986), 118 F.R.D. 29 (SDNY, 1987)).

faces a counterparty that is informed about the affairs of the company and the industry in which it operates.[10] Lending banks are far less likely than bondholders to negotiate in an opportunistic way because borrowers control who they borrow from; thus, a bank has an incentive to develop a reputation that will increase the flow of new business.[11]

Monitoring by lenders also reduces the agency costs of debt. Banks actively monitor borrowing firms for compliance with the terms of their loan contracts and for actions that might reduce the value of their loans, thus possibly preempting such actions. On-site examinations and meetings with management are not unusual.[12] Similar behavior is observed in private lending by insurance companies.[13] In public debt, such "preventive" monitoring does not take place because of the free rider problem. As a result, a borrowing firm's actions can go unchecked for a period of time before any harmful outcome is observed and by then it may be too late to limit the damage. The absence of monitoring by holders of public debt gives a firm greater leeway to engage in actions that transfer wealth from bondholders. Consequently, creditors demand commensurately higher yields on their public bonds to compensate them for this risk.[14]

The above discussion pointed out the advantages of private debt relative to public bonds in reducing the agency costs of debt. But, as we also pointed out, private loans are less liquid and harder to diversify than public bonds. In general, investors require higher

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[10] Carey et. al. *Op. cit.* p. 28-32, 36-38 and 43, Kahan and Tuckman *Op. cit.* Syndicated bank loans with many co-creditors provide for representation of creditor banks by a syndicate manager.
[11] Carey et. al. *Op. cit.* p. 44. The situation is similar with private placements (E. Zinbarg "The Private Placement Loan Agreement," *Financial Analysts Journal*, July/August 1975, 33-52).
[12] Saunders, A., *Financial Institutions*, Irwin, 1994, 55 - 56.
[13] See Carey et. al. *Op. cit.*, Kahan and Tuckman *Op. cit.*
[14] However, Smith and Warner, *Op. cit.* p. 146, observe that bondholders can require that a firm be monitored by, for example, insurance companies.

yields on investments in less liquid assets.[15] The ability to convert public bonds into cash quickly and cheaply is a valuable characteristic that, other things equal, creditors are willing to pay for in the form of higher bond prices and lower yields. Additionally, the relatively small unit size of public bond issues--typically $1,000 principal value--facilitates diversification of "idiosyncratic," or firm-specific, risk, thus enabling portfolio allocations with better risk-return characteristics even for small investors. This increases the potential investor base for the bonds and reduces the required yield.[16]

Borrowers choosing between public bonds and private loans thus face a trade-off.[17] Public bonds have superior liquidity and are more easily diversified, but have relatively few and weak covenants with limited control of the agency costs of debt. Private loans better control the agency costs of debt through tighter covenants, renegotiation, and closer monitoring, but are illiquid and their size limits diversification by small investors. At present, both choices – public debt with loose covenants and lack of monitoring and private loans with limited liquidity and diversifiability – impose some costs. Our proposal aims to combine the better features main advantages of each of these two types of debt.

[15] See K. Garbade, "Analyzing the Structure of Treasury Yields: Duration, Coupon and Liquidity Effects," *Topics in Money and Securities Markets*, Bankers Trust Company, 1984, reprinted in K. Garbade, 1996, *Fixed Income Analytics*, MIT Press; Y. Amihud, and H. Mendelson, "Asset Pricing and the Bid-Ask Spread," *Journal of Financial Economics,* December 1986, 223-249; W. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," *Financial Analysts Journal* July-August 1991, 60-64; and A. Kamara, "Liquidity, Taxes, and Short-Term Treasury Yields," *Journal of Financial and Quantitative Analysis,* September 1994, 403-417.

[16] See R. Merton, "A Simple Model of Capital Market Equilibrium with Incomplete Information," *Journal of Finance* July 1987, 483-510; and S. Mukherji, Y. Kim and M. Walker, "The Effect of Stock Splits on the Ownership Structure of Firms," *Journal of Corporate Finance* April 1997, 167-188.

[17] See Amihud and Mendelson, 1988, *Op. cit.* on the tradeoff between control and liquidity in publicly traded corporate claims.

THE PROPOSAL

This paper proposes an institutional innovation in the structure of public bonds intended to emulate the advantages of private loans--active monitoring, tight covenants and ease of recontracting--while retaining the benefits of liquidity and ease of diversification. We suggest that a publicly registered corporate bond provide for a "supertrustee" who will act on behalf of the dispersed and temporally changing bondholders. The supertrustee will be charged with responsibility to monitor the compliance of the borrower with the terms of the bond covenants and given exclusive authority to negotiate amendments to the covenants and to decide what action to take in the event of a breach of a covenant. By ameliorating the problems associated with the dispersion and fluidity of ownership of public debt, our proposal will allow the structure of public bond covenants to more closely resemble private loan agreements, with more and tighter covenants, active monitoring, and relatively inexpensive renegotiation. This will more effectively control the agency costs stemming from the conflict of interest between stockholders and bondholders while allowing an issuer to undertake projects that enhance the aggregate value of the firm. At the same time, because it is publicly traded, the debt will retain the benefits of liquidity and diversifiability.

The Trust Indenture Act of 1939 (hereafter, "the Act") presently requires appointment of a trustee for a publicly registered corporate bond.[18] However, the trustee contemplated by the Act has little responsibility to monitor compliance with bond covenants, no authority to renegotiate the terms of an indenture, and limited ability to

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[18] Smith and Warner, *Op. cit.* p. 148-151 and Landau, *Op. cit.*, describe the duties and powers of a trustee. Section 304 of the Act specifies certain securities exempted from the provisions of the Act.

choose what action to take following breach of a covenant.[19] The supertrustee that we propose would have substantially greater responsibilities and authority, including the authority to act independently of bondholders.

Our proposal is voluntary and market based. We do not propose to mandate the appointment of a supertrustee for all public bond issues but to allow appointment at the option of the issuer.[20] If the supertrustee is effective in reducing the agency costs of debt, it will reduce the issuer's borrowing costs in two ways. First, tighter bond covenants and greater monitoring by the supertrustee will reduce the yield required by investors. Second, the ability to renegotiate the debt contract will reduce the likelihood that the firm will be forced to forego value-increasing projects in the future.

The costs of the supertrustee will be paid by the bond issuer in the same way that issuers pay rating agencies to rate their bonds. The firm issuing a bond will consider the costs and benefits of having a supertrustee appointed for the bond and will choose to have one appointed if the benefits exceed the costs. Importantly, a supertrustee perceived by investors as ineffective may suit the borrower but will not bring about the expected reduction in the cost of borrowing, and so the benefits of the supertrustee in this case will not justify its costs.

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[19] Smith and Warner *Op. Cit.* 150 ("... while the trustee must act in good faith, his responsibilities often go no further unless there is a default.") and Landau, *Op. cit.,* 26 and 69 ("... duties of the trustee [prior to default] are largely administrative ...") and 140 ("... under the usual indenture [the trustee] has ... no authority or right to give any ... consent [to a change in the indenture] or waiver.").

[20] Similarly, the firm that issues the bond will specify, by contract, the rules under which the supertrustee operates, including its appointment and replacement and its compensation.

DUTIES OF THE SUPERTRUSTEE

The supertrustee is intended to emulate the behavior of a solitary creditor on a private loan--such as a bank--in obtaining information about a borrower and assessing covenant compliance, in renegotiating the terms of the indenture, and in deciding what action to take following breach of a covenant.

Monitoring. With respect to monitoring compliance with the bond indenture, the supertrustee will have access to non-public corporate documents, including financial statements and cash flow projections for subsidiaries and divisions. The supertrustee will also have access to the officers and directors of the firm and the firm's accountants--as well as communications between the firm and its accountants--if it requires additional information. On the basis of the information gathered, the supertrustee will be required to make an independent determination that the issuer is not in violation of any covenant.

The responsibility and authority of the supertrustee to monitor compliance differs significantly from the monitoring responsibilities of a conventional trustee.[21] The latter generally does not have access to non-public information and relies instead on public filings with the SEC, such as annual and quarterly reports.[22] More significantly, the conventional trustee does not have to assess compliance independently,[23] but can rely on annual compliance certificates submitted by the company stating that it is not in violation of any covenants.[24]

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[21] However, a conventional trustee does have substantial responsibility with respect to monitoring the release and substitution of property pledged as collateral for a mortgage bond Landau, *Op. cit.* p. 112 - 123.
[22] Landau *Op. cit.* p. 134 and Smith and Warner, *Op. cit.* p. 143.
[23] Landau, *Op. Cit.* at 70, observes that while "... it is usually provided that a trustee may make independent investigations ... of the performance by the obligor of its covenants ... it is recommended that an express qualification be inserted [in the indenture] to the effect that the trustee is under no duty to do so."
[24] Compliance *certificates* are described by Smith and Warner, *Op. cit.* p.145-146. Compliance certificates for public bonds are conclusory. They merely state whether or not a covenant has been breached and do not

Renegotiation. The supertrustee will be authorized to renegotiate the terms of a bond indenture independently of bondholder direction and without the need for approval by bondholders of its actions. This is a key element of our proposal because it eliminates the difficulty of the issuer negotiating indenture amendments with a fluid and dispersed group of creditors. We expect that lowering the cost of renegotiation of bond covenants will foster the inclusion of more and tighter covenants in public bond indentures, which will better control corporate behavior and lower the agency costs presently associated with public debt.

We further anticipate that the supertrustee will be well informed about the nature of the issuer's business (as a result of its monitoring obligations) and able to identify the merits and dangers of any proposed change in the indenture. This is in sharp contrast to the present situation, where individual bondholders have little incentive, and the conventional trustee no significant responsibility, to acquire information about the company. Under the current system, neither bondholders nor the trustee are well prepared to negotiate covenant changes.

Some indenture amendments entail relaxing a restrictive covenant in return for the firm making a lump sum payment to creditors or raising the coupon rate on a bond. More extreme amendments involve extending the maturity of the bond, deferring interest payments, or forgiving part of the contractual payments (including interest rate reductions and forgiveness of principal repayments). Such amendments are not uncommon in private workouts of distressed debt and can be in the best interests of creditors if the

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provide any supporting information. A supertrustee, like a private creditor, would be authorized to request detailed calculations affirmatively demonstrating compliance with a covenant.

alternative--forcing the firm to adhere to the original payment provisions—leads to a costly financial distress.[25]

Giving the supertrustee the power to approve changes in the core terms of a bond may be unacceptable to bondholders and is not essential to our proposal. Private loan agreements with multiple creditors provide that changes in core terms require the consent of every lender, whereas covenant changes require only the consent of a majority of lenders.[26] This suggests that creditors value the right to veto changes in core terms much more than the right to veto other covenant changes and that they would be reluctant to cede (to a supertrustee) power to approve changes in core terms.

On the other hand, the cost of obtaining the consent of a limited number of co-creditors on a private loan is much lower than the cost of obtaining such consent from many dispersed corporate bondholders. For this reason, giving the supertrustee the authority to renegotiate core terms may be more valuable for public bonds than for private loans. Section 316(b) of the Act presently requires unanimous approval of bondholders to changes in a bond's core terms.[27] The most extensive implementation of our proposal would therefore require legislative changes to this provision.

The discretion we propose for the supertrustee to renegotiate indenture provisions on behalf of bondholders may be considered far-reaching. However, stockholders delegate comparable discretionary authority to the board of directors and grant the board wide latitude in making decisions that materially affect shareholder wealth. In addition,

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[25] See S. Gilson, K. John and L. Lang, "Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default," *Journal of Financial Economics* October 1990, 315-353. See also C. Baldwin, and S. Mason, "The Resolution of Claims in Financial Distress: The Case of Massey Ferguson," *Journal of Finance* May 1983, 505-516.
[26] M. Roe, "The Voting Prohibition in Bond Workouts," *Yale Law Journal,* 1987, p. 274.

indenture trustees under English law presently have some discretion in renegotiating bond covenants and making modifications to indentures that (in the opinion of the trustee) are not materially prejudicial to the interests of bondholders.[28] (However, as a matter of practice, a trustee under U.K. law does not typically exercise its power to make substantial permanent covenant changes or agree to changes in covenants in return for changes in the core terms of a bond. Our proposal thus goes beyond the discretion presently practiced by English trustees. Additionally, a U.K. trustee does not have the significant monitoring obligations that we propose and hence may be less well informed than a supertrustee about the nature of a borrower's business.) Finally, under our proposal the supertrustee's discretion to renegotiate the terms of the bond indenture would be limited by the contract that determines what it can change without bondholder consent--and this can vary from one bond indenture to another.

Enforcement. Upon breach of a covenant, the supertrustee will have the power to decide whether to waive the breach for a specified period of time, or to amend the indenture to relax the covenant or to accelerate the maturity of the bond. Absent a payment default, it can exercise this power independently of bondholders and even contrary to their express preferences.

The enforcement power of a supertrustee is substantially greater than the enforcement power of a conventional trustee. While the latter has authority to accelerate the maturity of a bond following a defined "event of default," it shares that power with bondholders, who can independently declare a bond immediately due and payable as well

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[27] *Ibid.*

[28] We thank Phillip v. Randow, University of Osnabrueck and David Norris, Law Debenture Corporation p.l.c., for information about U.K. practice.

as reverse the decision of the trustee to accelerate maturity. A conventional trustee ordinarily has no authority to waive a breach of a covenant or to amend the indenture to relax a covenant. In addition, holders of a majority of outstanding bonds can direct a conventional trustee to take actions that they specify.[29]

INCENTIVE STRUCTURE OF A SUPERTRUSTEESHIP

We said earlier that the supertrustee is intended to emulate the behavior of a solitary private creditor in monitoring covenant compliance, in renegotiating the terms of the indenture, and in deciding what action to take following breach of a covenant. This behavior can be elicited with a variety of incentives regarding liability, compensation, and the power to appoint and replace the supertrustee.

Liability. In negotiating changes in a loan agreement and in enforcing the agreement, a private creditor takes account of the effect of its actions on the value of the loan *and also* on its reputation for non-opportunistic behavior.[30] The latter element is an important aspect of the creditor's ability to attract future business and also accounts for the willingness of the borrower to agree to tight covenants when the loan is originated: a borrower would be reluctant to agree to tight restrictions on its decision-making and stringent limits on its operating characteristics if it did not have confidence that those restrictions and limits will be relaxed when it is in the best interests of shareholders and not contrary to the interests of the creditor.

The supertrustee will have substantial powers and must be held accountable for its actions. However, the liability regime for the supertrustee should take account of the

[29] Landau *Op. cit.* pp. 140, 207.
[30] Carey et. al *Op. cit.* p. 42 - 44.

benefits to bondholders that derive from the supertrustee's reputation for non-opportunistic behavior. That is, the liability regime should not require that the supertrustee always make a decision that extracts the maximum immediate value for bondholders. This is because the issuer's interest is that if it agrees to tight covenants it can expect that those covenants will not be enforced opportunistically in case it later seeks a waiver or amendment. The regime should also recognize that the anticipated *ex post* behavior of the supertrustee affects the borrower's willingness to accept restrictive bond covenants in the first place.

We recommend that the supertrustee's decisions be evaluated under a standard analogous to the "business judgment rule" applicable to decisions by a board of directors, so that bondholders can not sue a supertrustee if its judgment is viewed as being merely wrong or substantively unreasonable.[31] This will allow the supertrustee the latitude needed to take account of the effect of its decisions on its own reputation.

The Trust Indenture Act of 1939 specifies a much stricter regime of trustee liability. Following a default, Section 315(c) of the Act prescribes that the indenture trustee must "use the same degree of care and skill [in exercising its enforcement powers] as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."[32] The prudent man rule would almost certainly deter a supertrustee from taking into account the effect of its decisions on its own reputation and almost certainly requires that a trustee act in the exclusive best interests of bondholders in a narrow sense. When

[31] They should, however, be able to bring a claim if the supertrustee acts in bad faith or in the presence of a disabling conflict of interest. The supertrustee's interest in acting non-opportunistically should not, for this purpose, constitute a disabling conflict of interest.

[32] It is common practice for a trustee under the Act to consult with, and seek guidance from, bondholders following default, thereby avoiding any significant liability under the prudent man rule (Landau, *Op. cit.*

applied to a supertrustee, this may not be in the best ex ante interests of the borrower and lenders.[33]

Section 315(d) of the Act provides more generally that the indenture trustee may not be relieved from liability for its own negligent actions or its own negligent failure to act.[34] However, this provision is modified by sections 315(a) and (b), which provide that, prior to default, the trustee must fulfill only those (relatively few) duties set forth in the indenture and that the trustee may rely on compliance certificates provided by the company. Our proposal envisions substantial pre-default duties for the supertrustee and would not allow the supertrustee to rely on corporate compliance certificates. Because our proposal contemplates greater duties than those commonly found in indentures qualified under the Act, Section 315(d) may be inconsistent with a business judgment standard for the supertrustee.[35]

Compensation. The compensation of a supertrustee should be commensurate with its duties and responsibilities. In broad terms, compensation should be greater for bonds with more complex covenants, for bonds issued by companies with more complicated and less transparent operating characteristics, and for bonds bearing more credit risk and for which more intense monitoring is appropriate and more renegotiation

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pp. 207-208).

[33] Landau, *Op. cit.* p. 53, observes that private placements (which are not subject to the provisions of the Act) that provide for a trustee usually do not impose a prudent man standard following default.

[34] Landau, *Op. cit.* p. 4, describes the reason for this prohibition on immunity provisions in a bond indenture.

[35] Exempting supertrustee bonds from the liability provisions of Section 315 does not necessarily require a legislative amendment to the Act. The Securities and Exchange Commission enjoys broad statutory authority to "exempt ... any security or transaction ... from any one or more provisions of [the Act], if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by" the Act.

is likely to be needed. As we discuss below, it is also in such cases that the benefits of using a supertrustee are likely to be greatest.

Given the considerable latitude in decision making available to the supertrustee, its compensation may include incentives to encourage it to fulfill its duties effectively.[36] The incentives can be penalties for poor performance, bonuses for superior performance, or both. Such incentive compensation should be positively related to changes in bond values resulting from the supertrustee's actions but not to changes in value that stem from matters beyond the supertrustee's control, such as changes in the general level of interest rates. Thus, compensation could be tied to changes in market values that result from variations in the bonds' credit risk. For example, the supertrustee could be compensated according to a schedule that simulates the value of an option--similar to the stock options granted to corporate managers and directors--which varies inversely with the spread between the yield on the bonds and the yield on Treasury debt.[37]

Appointment and Replacement. The supertrustee can be appointed by bondholders--just as stockholders choose a board of directors--or by the borrower, thereby emulating the situation in the private credit markets where a borrower chooses its creditors. Because the borrower is the party that decides whether a public bond issue will have a supertrustee, it should also be the party that decides how the supertrustee will be appointed.

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[36] However, bond rating agencies perform their tasks without such incentive-based compensation. The economic interest of a rating agency in preserving its reputation suffices as an incentive for diligence.

[37] This scheme, however, imposes penalties and delivers bonuses for reasons that may be unrelated to the actions of the supertrustee, such as fluctuations in the business outlook for the industry in which the firm operates. A similar criticism can be directed at executive stock options.

The choice between the two appointment schemes depends on whether, on balance, it is more desirable to enhance the incentive of the supertrustee to represent bondholder interests or whether it is more desirable to encourage non-opportunistic behavior by the supertrustee.[38] Giving the borrower the power to appoint the supertrustee will increase the sensitivity of prospective supertrustees to the cost of acquiring a reputation for opportunistic behavior in negotiating waivers and amendments to bond indentures.[39] (This does not imply that a supertrustee selected by the borrower will be indifferent to creditor interests. Investors will not accept a lower rate of interest on a supertrustee bond if they do not have confidence that the supertrustee will act responsibly and the borrower will have no incentive to select such a supertrustee.)

On the other hand, the responsiveness of the supertrustee to creditor concerns will be greater if bondholders have the power to elect a supertrustee after the bond has been issued. To reduce the borrower's anxiety that it may have to deal with an opportunistic supertrustee, the indenture might provide that if bondholders replace a supertrustee appointed by the borrower, they must elect the replacement from a list of candidates submitted by the borrower.

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[38] Under either scheme, there should be an exception permitting prompt replacement of the supertrustee in cases where it grossly neglects to fulfill its duties, acts in bad faith, or becomes subject to a disabling conflict of interest. The replacement procedure should enable a material fraction of the bondholders (for example, 25%) to move to have a supertrustee replaced. As long as a greater percentage (perhaps a majority) of bondholders do not oppose replacement, the supertrustee should be removed upon a finding by a court or arbitrator that the supertrustee has acted in a proscribed manner.

[39] Protection of non-public information is another reason for the borrower's desire to control the identity of the supertrustee. A major task of the supertrustee will be to seek information from the borrower and monitor the borrower. In doing so, the supertrustee will have access to non-public information, as is the situation now with private lenders such as banks (Saunders *Op. Cit.* at 55–56; E. Fama, "What's Special About Banks," *Journal of Monetary Economics,* January 1985, 29-39; and C. James, "Some Evidence on the Uniqueness of Bank Loans," *Journal of Financial Economics,* December 1987, 217-235. This activity is an important feature of financial intermediaries and a reason for their particular involvement in lending to information-problematic borrowers (see the discussion in Carey et. al., *Op. cit.* p. 44) which can be emulated by the supertrustee.

WHO MIGHT USE A SUPERTRUSTEE?

The supertrustee is a device to locate responsibility for monitoring, renegotiating, and enforcing a public bond indenture in a single entity. This enables borrowers and lenders to overcome the problems created by the dispersion and fluidity of public debt without sacrificing the liquidity and diversifiability of that debt. These benefits are not free, because the supertrustee will have to be compensated for the substantial responsibilities it undertakes. The supertrustee structure is economically efficient only if the added costs of a supertrustee are smaller than the benefits of (1) being able to issue debt at a lower rate of interest and (2) avoiding inflexible constraints on future actions.

We believe the supertrustee structure will be more desirable for debt issued by firms with greater inherent credit risk and less transparent operations and by firms in more volatile industries with significant intangible assets, such as entertainment and biotechnology.[40] In addition, because most of the costs of a supertrustee are fixed costs that do not vary with the size of an issue or the number of issues outstanding, the scheme will be relatively more attractive for larger bond issues and for issuers with more public indebtedness. The same supertrustee may be appointed to more than one bond issue of the same firm, and this would be economical because of economies of scale in the acquisition and use of information.

Finally, the proposed scheme will be more attractive for longer-term bonds for two reasons. First, there are temporal economies of scale in monitoring a company through time because information acquired in past years reduces the cost of monitoring

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[40] Carey et. al.,*Op. cit.*, characterize such firms as "information-problematic" borrowers.

the company in future years. Second, covenant protection is relatively more valuable on longer-term debt, as is the ability to renegotiate restrictive covenants and stringent minimum operating characteristics.

CONCLUSIONS

This paper has proposed an institutional innovation designed to lower the cost of credit obtained from issuing publicly traded bonds by reducing the agency costs of those bonds without impairing their liquidity or diversifiability. The proposal would focus responsibility for contract monitoring, renegotiation, and enforcement on a new entity, the supertrustee, and thereby seek to overcome the free rider problem associated with the dispersion of ownership of public debt. By emphasizing the economic significance of a supertrustee's reputation for responsible behavior, the proposal would also reduce the opportunistic behavior in contract renegotiation and enforcement that arises in part from the fluid ownership of public debt.

Some readers may question the desirability of our proposal and wonder why, if it is so beneficial, somebody hasn't already tried it. We have two responses. First, every innovation has to start someplace. Second, it may be that the increasing emphasis on encouraging corporate directors and executive officers to act to maximize shareholder value has only recently tipped the balance of public debt contract design in favor of more elaborate devices to reduce the agency costs of that debt.

Other readers may question the feasibility of our proposal, arguing that it is complex and uncertain of outcome. Our response is that we are not proposing to mandate a new architecture of debt contracting but rather to expand the menu available to market

participants. We would be surprised if the proposal were suitable for all but we do believe that some may find it appetizing.

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נספח ה-2: פניית השולחן העגול לאשראי ל-SEC לשיפור תהליך ההנפקה (מצגת)

Current Practices of the Corporate Bond Underwriting & Distribution Process and Recommendations for Improvement

The Credit Roundtable

Presentation to the SEC

March 3, 2009

Agenda

- Introduction of The Credit Roundtable, its purpose and membership.
- Description of the current process regarding underwriting and distribution of new issues in investment grade corporate bonds, including the effects of recent market conditions.
- Discussion of weaknesses in the current process, including impact on investors.
- Recommendations for improvement.
- Recommended next steps.

Overview of The Credit Roundtable (www.creditroundtable.org)

- The Credit Roundtable, formed in association with the Fixed Income Forum, is a group of approximately 65 large fixed income institutional asset managers representing over $2 trillion in fixed income assets under management. The group was formed in the spring of 2007, to discuss ways to enhance bondholder protections in the face of increasing numbers of leveraged buyout transactions and leveraged recapitalizations and other transactions that adversely impacted bondholder value.

- Assets managed for pension and 401(k) plans, endowments and foundations, insurance, corporate and other institutional clients, and individuals.

- Goals and areas of focus of The Credit Roundtable
  - Strengthen bondholder covenant protections (Covenant White Paper)
  - Review and improve the new issue underwriting and distribution process
  - Review and improve the tender/exchange and consent process
  - Educate the buy side community on the importance of protective covenants in investment grade bond indentures

- Supporting firms of the Covenant White Paper

40/86 Advisors
ABN AMRO Asset Management
ABP Investments US Inc.
Advantus Capital Management Inc.
Aetna Inc.
AIG Investments
AllianceBernstein L.P.
Allstate Investments, LLC
American Century Investments
Bear Stearns Asset Management
BlackRock Financial Management, Inc.
BNY Mellon Asset Management
California Public Employees' Retirement System
California State Teachers' Retirement System
Capital Research and Management Company
Capital Guardian Trust Company
CIGNA Investment Management
Claren Road Asset Management, LLC
Covenant Review, LLC
Deutsche Asset Management
Dodge & Cox
Dreyfus
European Credit Management Ltd.
Evergreen Investments
FBL Financial Group, Inc.
Fidelity Investments
First Investors
Franklin Templeton Fixed Income Group
Genworth Financial Investments Department
The Guardian Life Insurance Company of America
Halbis Capital Management
Hartford Investment Management Company
Income Research & Management
ING Investment Management Co.
John Hancock Financial
Knights of Columbus
Legal and General Investment Management America
Loomis, Sayles & Company, L.P.
Mason Street Advisors
MetLife, Inc.
MFS Investment Management
Nationwide Mutual Insurance Company
New York Life Investment Management, LLC
Oppenheim KAG
Pacific Life Insurance Company
PIMCO
PPM America, Inc.
Prudential Investment Management
Putnam Investments
SCM Advisors, LLC
Standish Mellon Asset Management
State Farm Insurance Companies
State of Wisconsin Investment Board
Thrivent Financial for Lutherans
TIAA-CREF
Torchmark Corporation
Toronto Dominion Asset Management
T. Rowe Price Group, Inc.
USAA Investment Management Company
The Vanguard Group, Inc.
Wellington Management Company, LLP
Wells Capital Management
Western Asset Management Co.
White Mountain Advisors LLC
Xtract Research LLC

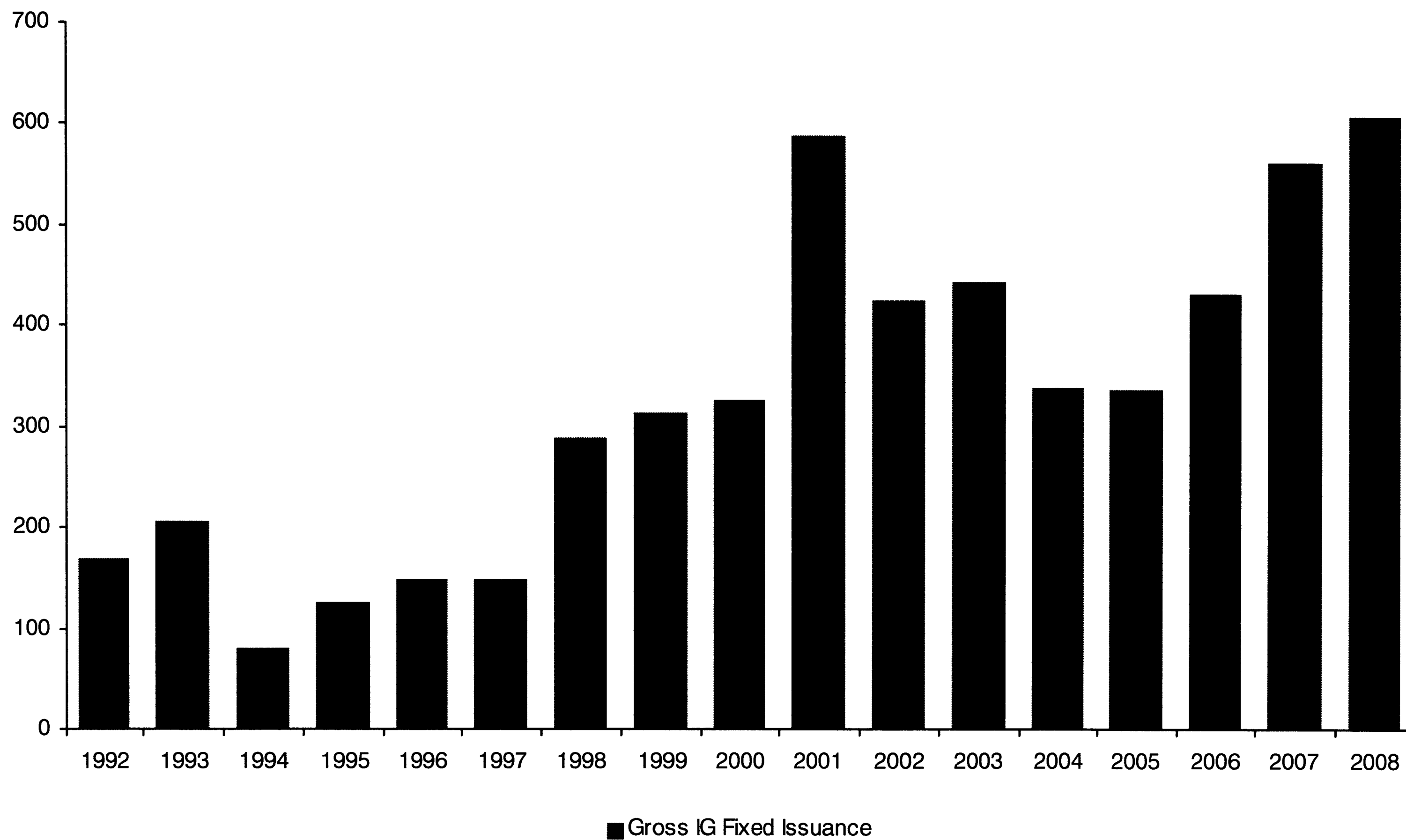
Weaknesses in the Underwriting and Distribution Process

1. Timing of Steps
2. Timeliness of Information: Preliminary Prospectus, Indenture and Other Due Diligence
3. Limited Disclosure
4. Post Transaction - Investor Protections, Recourse for Insufficient Disclosure

The current process allows investors a minimal amount of time (as little as 15 minutes) to make an investment decision without access to key disclosure documents and sufficient due diligence.

We are long term providers of capital and ultimately our clients, both large and small investors, will benefit if we have access to disclosures and are given adequate time to make investment decisions, thus creating more liquid and efficient capital markets.

Fixed Rate Investment Grade Corporate New Issuance (US$ bn)



The new issue market has grown substantially over time and multiple issuers often come to market on the same day, underlining the need for a better underwriting process that provides enough time to review each transaction.

Source: Barclays Capital

Investment Grade Corporate New Issuance

Below is a representative list of new issue activity during several days in 2009, illustrating the challenge of analyzing up to 8 separate issuers coming to market at once.

Issue Date	Issues	Principal	Coupon	Maturity
13-Jan-09	AMGEN INC	$1,000	5.700	2/1/2019
13-Jan-09	AMGEN INC	$1,000	6.400	2/1/2039
13-Jan-09	FEDEX CORP	$250	7.375	1/15/2014
13-Jan-09	FEDEX CORP	$750	8.000	1/15/2019
13-Jan-09	GOLDMAN SACHS GROUP INC	$3,500	1.625	7/15/2011
13-Jan-09	MACQUARIE GROUP LTD	$2,500	2.600	1/20/2012
13-Jan-09	MCDONALD'S CORP	$400	5.000	2/1/2019
13-Jan-09	MCDONALD'S CORP	$350	5.700	2/1/2039
13-Jan-09	PRINCETON UNIVERSITY	$500	4.950	3/1/2019
13-Jan-09	PRINCETON UNIVERSITY	$500	5.700	3/1/2039
13-Jan-09	REED ELSEVIER PLC	$550	7.750	1/15/2014
13-Jan-09	REED ELSEVIER PLC	$950	8.625	1/15/2019
13-Jan-09	UNIV OF NOTRE DAME	$150	4.141	9/1/2013
Total number of Issuers		8		
14-Jan-09	CAMPBELL SOUP CO	$300	4.500	2/15/2019
14-Jan-09	CSX CORP	$500	7.375	2/1/2019
14-Jan-09	DONNELLEY (R.R.) & SONS	$400	11.250	2/1/2019
14-Jan-09	METROPOLITAN EDISON	$300	7.700	1/15/2019
14-Jan-09	MORGAN STANLEY	$1,250	FRN	6/20/2012
14-Jan-09	MORGAN STANLEY	$250	FRN	6/20/2012
14-Jan-09	MORGAN STANLEY	$3,000	1.950	6/20/2012
14-Jan-09	PEPSI BOTTLING GROUP LLC	$750	5.125	1/15/2019
Total number of Issuers		6		
22-Jan-09	DUKE UNIVERSITY	$250	4.200	4/1/2014
22-Jan-09	DUKE UNIVERSITY	$250	5.150	4/1/2019
22-Jan-09	JERSEY CENTRAL PWR & LT	$300	7.350	2/1/2019
22-Jan-09	LUBRIZOL CORP	$500	8.875	2/1/2019
22-Jan-09	TENNESSEE GAS PIPELINE	$250	8.000	2/1/2016
Total number of Issuers		4		
29-Jan-09	AT&T INC	$1,000	4.850	2/15/2014
29-Jan-09	AT&T INC	$2,250	5.800	2/15/2019
29-Jan-09	AT&T INC	$2,250	6.550	2/15/2039
29-Jan-09	CONOCOPHILLIPS	$1,500	4.750	2/1/2014
29-Jan-09	CONOCOPHILLIPS	$2,250	5.750	2/1/2019
29-Jan-09	CONOCOPHILLIPS	$2,250	6.500	2/1/2039
29-Jan-09	HESS CORP	$1,000	8.125	2/15/2019
29-Jan-09	HUNTINGTON NATIONAL BANK	$600	0.819	6/1/2012
Total number of Issuers		4		
3-Feb-09	ALTRIA GROUP INC	$525	7.750	2/6/2014
3-Feb-09	ALTRIA GROUP INC	$2,200	9.250	8/6/2019
3-Feb-09	ALTRIA GROUP INC	$1,500	10.200	2/6/2039
3-Feb-09	POOLED FUNDING TRUST I	$414	2.740	2/15/2012
3-Feb-09	PROCTER & GAMBLE CO	$750	3.500	2/15/2015
3-Feb-09	PROCTER & GAMBLE CO	$1,250	4.700	2/15/2019
3-Feb-09	PROCTER & GAMBLE INTL FN	$1,000	FRN	2/8/2010
3-Feb-09	SUNOCO LOGISTICS PARTNER	$175	8.750	2/15/2014
3-Feb-09	SWEDBANK AB	$250	FRN	2/10/2012

Issue Date	Issues	Principal	Coupon	Maturity
4-Feb-09	BANK OF AMERICA NA TLGP	$2,300	FRN	2/5/2010
4-Feb-09	CME GROUP INC	$750	5.750	2/15/2014
4-Feb-09	GEORGIA POWER COMPANY	$500	5.950	2/1/2039
4-Feb-09	GOLDMAN SACHS GROUP INC	$600	FRN	11/9/2011
4-Feb-09	NOVARTIS CAPITAL CORP	$2,000	4.125	2/10/2014
4-Feb-09	NOVARTIS SECS INVEST LTD	$3,000	5.125	2/10/2019
Total number of Issuers		5		
17-Feb-09	COCA-COLA ENTERPRISES	$350	3.750	3/1/2012
17-Feb-09	COCA-COLA ENTERPRISES	$250	4.250	3/1/2015
17-Feb-09	E.I. DU PONT DE NEMOURS	$400	4.750	3/15/2015
17-Feb-09	E.I. DU PONT DE NEMOURS	$500	5.750	3/15/2019
17-Feb-09	HONEYWELL INTERNATIONAL	$600	3.875	2/15/2014
17-Feb-09	HONEYWELL INTERNATIONAL	$900	5.000	2/15/2019
17-Feb-09	UNION PACIFIC CORP	$350	5.125	2/15/2014
17-Feb-09	UNION PACIFIC CORP	$400	6.125	2/15/2020
Total number of Issuers		4		
18-Feb-09	CANADIAN NATL RAILWAY	$550	5.550	3/1/2019
18-Feb-09	GOODRICH CORP	$300	6.125	3/1/2019
18-Feb-09	JPMORGAN CHASE & CO	$1,000	FRN	2/23/2011
18-Feb-09	JPMORGAN CHASE & CO	$2,000	1.650	2/23/2011
18-Feb-09	JPMORGAN CHASE & CO	$4,000	FRN	6/15/2012
18-Feb-09	JPMORGAN CHASE & CO	$3,000	2.200	6/15/2012
18-Feb-09	ROCHE HLDGS INC	$3,000	FRN	2/25/2010
18-Feb-09	ROCHE HLDGS INC	$750	FRN	2/25/2011
18-Feb-09	ROCHE HLDGS INC	$2,500	4.500	3/1/2012
18-Feb-09	ROCHE HLDGS INC	$2,750	5.000	3/1/2014
18-Feb-09	ROCHE HLDGS INC	$4,500	6.000	3/1/2019
18-Feb-09	ROCHE HLDGS INC	$2,500	7.000	3/1/2039
18-Feb-09	ROCHE HLDGS INC	$4,500	6.000	3/1/2019
18-Feb-09	ROCHE HLDGS INC	$2,500	7.000	3/1/2039
Total number of Issuers		4		
23-Feb-09	ARIZONA PUBLIC SERVICE	$500	8.750	3/1/2019
23-Feb-09	BAXTER INTERNATIONAL INC	$350	4.000	3/1/2014
23-Feb-09	HEWLETT-PACKARD CO	$275	FRN	2/24/2011
23-Feb-09	HEWLETT-PACKARD CO	$1,000	4.250	2/24/2012
23-Feb-09	HEWLETT-PACKARD CO	$1,500	4.750	6/2/2014
23-Feb-09	ROYAL BK OF SCOTLAND PLC	$750	FRN	2/24/2012
23-Feb-09	WASTE MANAGEMENT INC	$350	6.375	3/11/2015
23-Feb-09	WASTE MANAGEMENT INC	$450	7.375	3/11/2019
23-Feb-09	WESTERN UNION CO	$500	6.500	2/26/2014
Total number of Issuers		6		

Typical New Issue Timeline (Eastern time)

Time	Step
9:00 AM	Underwriters *announce* a new issue and alert investors via Bloomberg system and phone.
	Sales force begins discussions regarding investors' interest and pricing expectations (price discovery).
	Investors attempt to evaluate the issuer's credit quality and prospectus terms.
	Investors *submit an order* without finalized pricing or terms.
9:15 AM	Documentation (preliminary prospectus) is provided to investors, which may include only a summary of key provisions in the indenture.
	Offering *goes subject* and *books are closed* (i.e. orders of interest are no longer accepted).
10:00 AM	*Price guidance*, or an indicative pricing range, is announced.
11:00 AM	Deal is *launched* with final pricing and settlement terms which can differ meaningfully from price guidance.
4:00 PM	Underwriters set and release allocations to investors.
4:30 PM	Deal is *priced* near market close, causing difficulty in hedging interest rate exposure or selling securities to finance the purchase.

Investors have as little as 15 minutes to evaluate prospectus terms (often which are not available), the issuer's credit story, and pricing expectations. For the large majority of new issue transactions, there is no conference call with the management of the issuer.

Weakness 1

1. Timing of Steps in the Process

- Period from announcement to order submission (close of books) is too short in many cases.
- Investors do not have adequate time for due diligence and to negotiate terms.
  - Changes in technology have increased the speed of marketing new issues and shortened the period available for credit research (e.g. broadly distributed virtual roadshows now common instead of conference calls or management presentations).
- Pricing near the end of the trading day poses problems for hedging or swaps that need to be done against the new issue, resulting in exposure to potentially harmful movements in interest rates.

Weakness 2

2. Timeliness of Information: Preliminary Prospectus, Indenture and Other Due Diligence

- Preliminary prospectus often not available at deal announcement for review of covenants and terms.
- Indentures are often inaccessible (may be on file but may not be easily identifiable).
- Rating agencies' revised opinions may not be available at deal announcement.
    - Example: Amgen 5.85% due 2017 (rating outlooks revised after deal was announced).
- Investors' ability to conduct proper diligence is significantly diminished without conference calls, roadshow slides or presentations.
    - Direct access to company management provides a forum for questions and allows greater insight into business operations and capital structure intentions.

Weakness 3

3. Limited Disclosure

- Existence of financial maintenance covenants (leverage and coverage tests) may be disclosed, but may be difficult to calculate from publicly available financial statements.
  - Example: HCA indenture refers to Restricted Subsidiaries but subsidiaries not clearly specified.
- Covenant descriptions may be imprecise or confusing.
- Limited availability of indentures and prospectuses (see section 2. Timeliness of Information).
- Each issuer uses its own legal terms including covenants; lack of standardization requires more time to analyze each legal agreement (the Credit Roundtable published the "*Covenant White Paper*" providing "model" covenants to address this issue).
- Risk factors are often generic and lack company specific details that are important to investment decisions.

Weakness 4

4. Post Transaction - Investor Protections, Recourse for Lack of Disclosure

- Investors have little recourse if issuers announce follow-on debt issuance or M&A activities shortly after an offering.
  - Issuers sometimes take actions that materially alter their capital structure to the detriment of debtholders within a short time frame after debt issuance.
  - Examples (action: period after last issuance): Alcoa (Alcan bid: 4 months), BSX (Guidant bid: 2 weeks), CSX (stock buyback: 2 weeks), Harrah's (private equity LBO: 6 months), HCA (private equity LBO: 5 months), Realogy (private equity LBO: 2 months).
- Investors have limited ability to enforce the fiduciary duty of the indenture trustee to bondholders.

Recommendations for Improvement

1. Timing of Steps

- Allow more time for appropriate due diligence before books are closed and orders of interest are no longer accepted.
- Price a new issue early enough to allow for hedging interest rate exposures and other offsetting transactions.

2. Timeliness of Information and Due Diligence

- Simultaneous availability of all marketing documents at new issue announcement.
- Hyperlinks to documents incorporated by reference (e.g. indentures) within the Prospectus.
- Access to management through direct communication (conference calls at the minimum).

3. Limited Disclosure

- Clearer and more detailed disclosure of Use of Proceeds, Risk Factors, defined terms and covenant definitions.
- Capital structure.

4. Post Transaction

- Review standards for describing potential post-transaction capital raising and similar events.
- "Lookback"-style provisions.

נספח ה-3: המלצות השולחן העגול לאשראי בשיתוף פורום חוב בארצות הברית בדבר תניות חוזיות ואמות מידה פיננסיות רצויות

Publication Copy

www.creditroundtable.org

Improving Covenant Protections in the Investment Grade Bond Market

December 17, 2007
(updated as of July 2, 2008)

The Credit Roundtable is an association of fixed income investors seeking to improve the protective covenants in investment grade bond indentures. These investors, assembled under the auspices of the Fixed Income Forum, have come together to prepare and publish this covenant white paper. The purpose of this document is to identify those features of the investment grade covenant packages in use today that are most objectionable to bondholders and to suggest a set of model covenants for investment grade bond deals. The members of the Credit Roundtable appreciate that not every one of the suggested model covenants will be appropriate for every issuer for every deal. It is our hope, however, that the model covenants can and will be used to facilitate covenant negotiations in every deal. Some issuers will elect to include all of the model provisions in order to improve their market access or the rate on their bonds. Issuers that are more concerned with flexibility than rate may elect not to utilize some or all of the model provisions. This document will still be useful in the context of offerings by those issuers in that it will help investors to properly value the covenant protections that are missing in those deals.

The proposed model covenants attempt to fairly balance the desire of issuers to retain flexibility to run their businesses in the normal course without restriction and the expectation of bond investors that their covenants will protect them against substantial credit deterioration through voluntary actions by issuers. However, additional tailoring to adjust these model provisions to the circumstances of particular issuers and particular market conditions is appropriate and to be expected. The model provisions do not attempt to provide alternative "baskets" and "carve-outs" for every possible circumstance. The model provisions are attached as Annex A in the form of riders that can be used to add one or more of the proposed model covenants to an offering document. These riders cover the following topics:

- *Change of Control*
- *Step-Up Coupons*
- *Limitation on Liens and Priority Debt*
- *Reporting Obligations*
- *Voting by Series*

The Credit Roundtable is calling for verbatim disclosure of indenture provisions in offering documents since the exact wording of these provisions can be material to investors. Some "plain English" descriptions of covenants in recent transactions have made it difficult for investors to fully understand the exact nature of the covenant protections being offered. We believe a verbatim approach makes more sense for issuers and underwriters as it reduces the possibility that an offering document will contain a material misstatement or omission.

We hope that these materials will help to identify the most common limitations in the protections provided by currently used investment grade covenants and improve the dialogue in the marketplace between issuers and bond investors about these important provisions. Recent changes to the offering process have accelerated the speed at which bond offerings are completed and have made dialogue about covenants during an offering more difficult. Members of the Credit Roundtable are hopeful that publication of these sample covenants will facilitate discussions of covenant terms before offerings are launched as well as during the new issue marketing process. Ideally, issuers will either adopt these model provisions in full or will note to prospective purchasers the ways in which a proposed set of covenants differs from the model provisions. The model provisions included in Annex A and the text below are designed to help to focus market participants on the key issues that arise in preparing the covenants for a particular transaction. Included in Annex B are the "Top 10 Questions" that every bond investor should ask before investing in any new investment grade offering. We hope that this document will help issuers and bondholders communicate more effectively and complete transactions more efficiently with a reduced risk of misunderstanding.

Change of Control

The Limitations in the Precedent. The purpose of a change of control covenant is to provide each bondholder with an opportunity to rethink her original investment decision if the issuer is acquired by new owners. The high yield market version of the change of control covenant permits each bondholder to "put" her bond back to the issuer at 101% of principal amount (plus accrued interest) in the event of a "Change of Control" (as defined). Many of the investment grade covenants have a two-part trip wire for this "put" right, requiring *both* a "change of control" and a "below investment grade rating event" in order to trigger the bondholder "put" right. Many issuers feel that a double-trigger approach is more appropriate for investment grade bonds. However, the double-trigger approach has produced a number of unexpected outcomes, as ratings agencies have not always behaved in the way the draftsmen of some of these covenants imagined. In fact, a surprising number of the existing Change of Control covenants suffer from one or more of the following shortcomings:

- some existing precedent does not apply to an acquisition of the issuer by another public company in a merger transaction, because the resultant surviving corporation is not more than 50% owned by any single "person" or "group";

- some "Change of Control" definitions do not include a sale of all or substantially all of the issuer's consolidated assets;

- some of the double-trigger provisions have failed to properly capture the timing of a ratings downgrading and have, therefore, overlooked change of control transactions that have had severely negative credit implications;

- still other double-trigger mechanisms have called for rating agencies to publicly state that their downgrade was caused by the change of control transaction and the rating agencies have not always been willing or able to do so; and

- some existing precedent does not properly respond to the implications of a cessation in ratings by multiple rating agencies, either following a going-private transaction where the issuer is no longer required to make financial information available to the agencies on a timely basis or due to a decision by an issuer not to maintain a rating for any other reason.

The Proposed Model Provision. Members of the Credit Roundtable believe that a fully functioning change of control covenant should apply to all corporate takeovers, regardless of the structure and regardless of the impact on rating. However, in cases where a double-trigger approach is agreed, the shortcomings described above should be remedied. In the model provision included in Annex A, we are proposing standard language for both a single-trigger and a double-trigger change of control covenant. The model version addresses the shortcomings identified above as follows:

- a public company stock-for-stock merger is treated as a change of control unless the bond issuer's stockholders end up with more than 50% of the voting stock of the surviving company;

- a sale of "all or substantially all" of the issuer's assets is treated as a change of control (in addition to being subject to the "Merger, Sale of Assets" provisions of the indenture), although internal reorganizations are specifically excluded;

- the double-trigger provisions only require that there be a temporal link between the change of control and the rating decline and do not require any rating agency testimony as to the cause of the downgrade. If the bonds cease to be rated investment grade at any time during a test period that straddles the change of control event, the second trigger is deemed to be satisfied; and

- the bonds are treated as ceasing to be "investment grade" unless at least two of the three identified rating agencies continue to rate the bonds at the investment grade level during the trigger period that straddles the change of control event. Thus, a single withdrawn rating is disregarded but multiple withdrawn rating situations can amount to a loss of investment grade status that will satisfy the requirements of the second trigger.

Step-Up Coupons

The Limitations in the Precedent. The senior bank market has employed various "grid pricing" arrangements for many years, with the most common formulations tying the applicable spread over LIBOR to the borrower's leverage ratio or debt ratings. A similar philosophy

underlies ratings-based pricing in the investment grade bond market: if the credit deteriorates, the interest rate should increase. These step-up coupon provisions are arguably distinguishable from other investor protections in that they are not necessarily triggered exclusively by voluntary issuer actions. Ratings can decline for any number of reasons, including as a result of both voluntary and involuntary events. Arguably, with a proper "Limitation on Liens and Priority Debt" covenant (discussed below) and a proper "restricted payments" covenant,[*] ratings-based pricing adjustments should not be necessary. However, some issuers and bond investors may feel that a ratings-based pricing mechanism is a reasonable alternative to a meaningful covenant package that addresses all of the voluntary actions that can cause abrupt credit deterioration. The Credit Roundtable's members recognize that step-up coupon provisions will not be appropriate in every deal. The model provisions include a step-up mechanism because it is likely to continue to be employed by issuers to address bondholder credit concerns in some deals and having standardized language for those situations will be a benefit to all market participants.

There are a number of shortcomings in the ratings-based interest rate adjustment mechanisms currently in use in the market, including:

- most ratings-based pricing mechanisms are capped at a level that does not begin to compensate bondholders for the loss in value associated with a precipitous ratings decline;
- some of these mechanisms do not properly address the issues that arise if one or more of the originally designated ratings agencies ceases to rate the notes; and
- some of the precedent includes a "fall-away" provision whereby the step-up mechanism is forever eliminated if the bonds are upgraded beyond a specified level.

The Proposed Model Provision. Members of the Credit Roundtable believe that a fully functioning ratings-based interest adjustment mechanism should not require the investors to bear the risk that the rating agencies cease to rate the bonds — that risk properly belongs with the issuer, since the issuer is best positioned to manage the risk. The model provision addresses the short-comings described above as follows:

- if only one agency drops its rating, the dropped rating is disregarded for purpose of the interest rate adjustment provision. If more than one of the three identified rating agencies ceases to rate the bonds, however, that is taken into account and can result in an interest rate adjustment;
- issuers are not allowed to manipulate ratings by replacing Rating Agencies; and

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[*] *A typical "restricted payments" covenant would limit an issuer's ability to spin off major divisions, engage in credit-destructive leveraged recapitalizations or consummate a leveraged buyout. All of these are voluntary actions and could be limited within a set of agreed upon parameters through a "restricted payments" covenant that properly balanced issuer needs and bondholder concerns.*

- the "fall-away" provision has been eliminated.

Limitation on Liens and Priority Debt

The Limitations in the Precedent. The traditional "Liens" covenant in an investment grade indenture is intended to limit the amount of additional debt that the issuer is permitted to incur that is effectively senior to the bonds issued under that indenture. Surprisingly, many of the examples of this covenant found in indentures in use today do no such thing. These ineffective examples suffer from one or more of the following shortcomings:

- the restrictions only apply to new debt that is secured and ignore the fact that new debt can be structurally senior to the indenture's bonds if it is incurred at a subsidiary level or is guaranteed by subsidiaries of the issuer;

- some examples only apply to the issuer and its "Restricted Subsidiaries" and have no meaningful limitation on the issuer's ability to declare current or future subsidiaries to be "unrestricted" (and thereby outside of the reach of the covenant);

- some examples only restrict liens on items of property, plant and equipment that constitute "Principal Property," thereby overlooking liens on accounts receivable, inventory, intellectual property and other valuable corporate assets;

- in other cases, the term "Principal Property" is defined with such a high threshold of materiality that most (or even all) of the issuer's assets are excluded from the definition;

- in still other cases, "Principal Property" is defined to exclude stock (or intercompany payables) of the subsidiaries that own the issuer's property, plant and equipment, thereby permitting indirect security interests in those same assets through liens on stock (or intercompany payables) of subsidiaries; and

- finally, most existing "Liens" covenants allow the issuer to incur unlimited secured debt (including secured debt with a much shorter maturity than the indenture's bonds) so long as the indenture's bonds are secured "equally and ratably" with the new debt for so long as the new debt is so secured. In the context of a leveraged buyout or leveraged recapitalization, this "equal and ratable" clause can yield the unexpected result that the investment grade bonds are suddenly sharing collateral with a massive amount of new debt incurred in a voluntary transaction that has a material adverse impact on creditworthiness.

The Proposed Model Provision. A proper limitation on liens covenant needs to limit the amount of debt that can be incurred by the issuer or any of its subsidiaries that is effectively senior to the bonds. In the model provision included in Annex A, we are proposing a new approach to the traditional "Liens" covenant entitled "Limitation on Liens and Priority Debt." The model version addresses the shortcomings identified above as follows:

- debt of non-guarantor subsidiaries is considered to be "Priority Debt" and is, therefore, subject to the covenant's limitations;

- the covenant's limitations apply to the issuer and each of its subsidiaries and there is no ability to remove subsidiaries from the purview of the covenant by declaring them to be "Unrestricted";

- there is no "Principal Property" definition. Instead, the covenant applies to all assets, but is subject to a list of negotiated exceptions that will be tailored to fit the facts of each deal; and

- the "equal and ratable" clause has been eliminated (with the effect that the permission to incur unlimited secured debt has also been eliminated).

The model "Limitations on Liens and Priority Debt" covenant obviates the need for a separate sale and leaseback covenant because "Attributable Debt" arising out of sale and leaseback transactions is treated as "Priority Debt" for purposes of the model provision.

Reporting Obligations

The Limitations in the Precedent. On more than a few occasions in recent years, issuers of investment grade bonds have withdrawn from the periodic reporting requirements of the Securities Exchange Act of 1934. The resulting absence of information about these issuers has made it difficult for bond investors to properly evaluate the creditworthiness of these issuers and has had a detrimental impact on the trading markets for their bonds. Members of the Credit Roundtable believe that bondholders are entitled to reasonable access to financial information about an issuer for as long as it has bonds outstanding.

The Proposed Model Provision. The model reporting covenant draws on the experience of the "144A-for-life" market and calls for public disclosure that will satisfy the needs of bondholders without requiring issuers to bear the substantial costs of compliance with all of the Securities and Exchange Commission's regulations. The model provision would require an issuer that is no longer required to make SEC filings to continue to produce unaudited quarterly and audited annual financial statements, together with a management report on results of operations and financial condition, and make them available to current and prospective bondholders on a public-access website. This compromise allows issuers to avoid unnecessary expense while continuing to provide sufficient information to the public to support a healthy level of after-market trading.

Voting by Series

The Limitations in the Precedent. Many existing investment grade indentures permit amendments or waivers to be approved by the holders of a majority in aggregate principal amount of the notes then outstanding under that indenture, regardless of how many series of notes may at the time be outstanding under the indenture and regardless of the differences between the economic interests of the holders of each series of bonds. The members of the Credit Roundtable believe that this seemingly harmless administrative provision can produce

inappropriate outcomes. The holder of a note with a remaining maturity of 30 days may have a very different credit perspective than a holder of a note with a remaining maturity of 30 years. For example, in a consent solicitation under an indenture that does not provide for voting by series, the holders of the short-term notes under the indenture may be in a position to bargain away the rights of the long-term noteholders.

The Proposed Model Provision. The model provision would require voting by series (rather than by indenture) where an individual series is of a sufficient size to justify this right. The Credit Roundtable's members recognize that it may make sense to group multiple smaller series together for voting purposes (for example, in a Medium Term Note program) or to combine two or more series with near identical terms. The model provision seeks to balance the issuers' need for administrative convenience with the investors' concern that one series of notes could approve an amendment or waiver that would adversely affect a different series of notes.

Conclusions

Investment grade bonds bear a lower interest rate than bonds issued by lesser credits because they are thought by investors to be less risky investments. Purchasers of these bonds are prepared to accept the risk of loss associated with a general decline in the issuer's industry, or even its business in particular. However, many investment grade bond investors are not prepared to accept the risk of loss associated with the credit deterioration that results from voluntary acts taken by management. Many of the investment grade covenant packages in use today do not properly restrict voluntary issuer actions that erode bondholder value, such as leveraged recapitalization or leveraged buyouts. The members of the Credit Roundtable believe it is time to revisit these important indenture provisions and modify them to suit modern market circumstances.

The Following Firms Support this Document:

40|86 Advisors
ABN AMRO Asset Management
ABP Investments
Advantus Capital Management Inc.
Aetna Inc.
AIG Investments
AllianceBernstein L.P.
Allstate Investments, LLC
American Century Investments
Bear Stearns Asset Management
BlackRock Financial Management, Inc.
BNY Mellon Asset Management
California Public Employees' Retirement System
California State Teachers' Retirement System
Capital Research and Management Company
Capital Guardian Trust Company
CIGNA Investment Management
Claren Road Asset Management, LLC
Covenant Review, LLC
Deutsche Asset Management
Dodge & Cox
Dreyfus
European Credit Management Ltd.
Evergreen Investments
FBL Financial Group, Inc.
Fidelity Investments
First Investors
Franklin Templeton Fixed Income Group
The Guardian Life Insurance Company of America
Genworth Financial Investments Department
Halbis Capital Management
Hartford Investment Management Company
Income Research & Management
ING Investment Management Co.
John Hancock Financial
Knights of Columbus
Legal and General Investment Management America
Loomis, Sayles & Company, L.P.
Mason Street Advisors
MetLife, Inc.
MFS Investment Management
Nationwide Mutual Insurance Company
New York Life Investment Management, LLC
Oppenheim KAG
Pacific Life Insurance Company
PIMCO
PPM America, Inc.
Prudential Investment Management
Putnam Investments
SCM Advisors, LLC
Standish Mellon Asset Management
State Farm Insurance Companies®
State of Wisconsin Investment Board
Thrivent Financial for Lutherans
TIAA-CREF
Torchmark Corporation
Toronto Dominion Asset Management
T. Rowe Price Group, Inc.
USAA Investment Management Company
The Vanguard Group, Inc.
Wellington Management Company, LLP
Wells Capital Management
Western Asset Management Co.
White Mountains Advisors LLC
Xtract Research LLC

<u>**Annex A**</u>

Suggested Riders to Prospectus Supplement

<u>Rider 1</u>

Offer to Redeem Upon Change of Control [Triggering Event]. Upon the occurrence of a Change of Control [Triggering Event], unless the Company has exercised its right to redeem the Notes as described under "—Redemption at the Company's Option" or "—Redemption Upon Changes in Withholding Taxes," the Indenture provides that each Holder of Notes will have the right to require the Company to purchase all or a portion of such Holder's Notes pursuant to the offer described below (the "***Change of Control Offer***"), at a purchase price equal to 101% of the principal amount thereof plus accrued and unpaid interest, if any, to the date of purchase, subject to the rights of Holders of Notes on the relevant record date to receive interest due on the relevant interest payment date.

Within 30 days following the date upon which the Change of Control [Triggering Event] occurred, or at the Company's option, prior to any Change of Control but after the public announcement of the pending Change of Control, the Company will be required to send, by first class mail, a notice to each Holder of Notes, with a copy to the trustee, which notice will govern the terms of the Change of Control Offer. Such notice will state, among other things, the purchase date, which must be no earlier than 30 days nor later than 60 days from the date such notice is mailed, other than as may be required by law (the "***Change of Control Payment Date***"). The notice, if mailed prior to the date of consummation of the Change of Control, will state that the Change of Control Offer is conditioned on the Change of Control being consummated on or prior to the Change of Control Payment Date.

Holders of Notes electing to have Notes purchased pursuant to a Change of Control Offer will be required to surrender their Notes, with the form entitled "Option of Holder to Elect Purchase" on the reverse of the Note completed, to the paying agent at the address specified in the notice, or transfer their Notes to the paying agent by book-entry transfer pursuant to the applicable procedures of the paying agent, prior to the close of business on the third business day prior to the Change of Control Payment Date.

The Company will not be required to make a Change of Control Offer if a third party makes such an offer in the manner, at the times and otherwise in compliance with the requirements for such an offer made by the Company and such third party purchases all Notes properly tendered and not withdrawn under its offer.

"Change of Control" means the occurrence of any one of the following:

(1) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or a series of related transactions, of all or substantially all of the assets of the Company and its Subsidiaries taken as a whole to any Person (including any "person" (as that term is used in Section 13(d)(3) of the Exchange Act)) other than to the Company or one of its Subsidiaries;

(2) the consummation of any transaction (including without limitation, any merger or consolidation) the result of which is that any Person (including any "person" (as that term is used in Section 13(d)(3) of the Exchange Act)) becomes the "beneficial owner" (as defined in Rules 13d-3 and 13d-5 under the Exchange Act), directly or indirectly, of more than 50% of the outstanding Voting Stock of the Company, measured by voting power rather than number of shares;

(3) the Company consolidates with, or merges with or into, any Person, or any Person consolidates with, or merges with or into, the Company, in any such event pursuant to a transaction in which any of the outstanding Voting Stock of the Company or such other Person is converted into or exchanged for cash, securities or other property, other than any such transaction where the shares of the Voting Stock of the Company outstanding immediately prior to such transaction constitute, or are converted into or exchanged for, a majority of the Voting Stock of the surviving Person immediately after giving effect to such transaction;

(4) the first day on which the majority of the members of the board of directors of the Company cease to be Continuing Directors; or

(5) the adoption of a plan relating to the liquidation or dissolution of the Company.

"Change of Control Triggering Event" means the Notes cease to be rated Investment Grade by at least two of the three Rating Agencies on any date during the period (the "***Trigger Period***") commencing 60 days prior to the first public announcement by the Company of any Change of Control (or pending Change of Control) and ending 60 days following consummation of such Change of Control (which Trigger Period will be extended following consummation of a Change of Control for so long as any of the Rating Agencies has publicly announced that it is considering a possible ratings change). Unless at least two of the three Rating Agencies are providing a rating for the Notes at the commencement of any Trigger Period, the Notes will be deemed to have ceased to be rated Investment Grade by at least two of the three Rating Agencies during that Trigger Period. Notwithstanding the foregoing, no Change of Control Triggering Event will be deemed to have occurred in connection with any particular Change

of Control unless and until such Change of Control has actually been consummated.

"Continuing Director" means, as of any date of determination, any member of the board of directors of the Company who:

(1) was a member of such board of directors on the date of the Indenture; or

(2) was nominated for election or elected to such board of directors with the approval of a majority of the Continuing Directors who were members of such board of directors at the time of such nomination or election.

"Fitch" means Fitch Inc., a subsidiary of Fimalac, S.A., and its successors.

"Investment Grade" means a rating of Baa3 or better by Moody's (or its equivalent under any successor rating category of Moody's); a rating of BBB- or better by S&P (or its equivalent under any successor rating category of S&P); and a rating of BBB- or better by Fitch (or its equivalent under any successor rating category of Fitch).

"Moody's" means Moody's Investors Service, Inc., a subsidiary of Moody's Corporation, and its successors.

"Person" means any individual, corporation, partnership, joint venture, association, joint-stock company, trust, unincorporated organization, limited liability company or government or other entity.

"S&P" means Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., and its successors.

"Rating Agency" means each of Moody's, S&P and Fitch; *provided,* that if any of Moody's, S&P and Fitch ceases to provide rating services to issuers or investors, the Company may appoint a replacement for such Rating Agency that is reasonably acceptable to the trustee under the Indenture.

"Voting Stock" of any specified Person as of any date means the capital stock of such Person that is at the time entitled to vote generally in the election of the board of directors of such Person.

Rider 2

Interest Rate Adjustment Based on Rating Events. The Indenture provides that the interest rate payable on the Notes will be subject to adjustment from time to time if any of the three Rating Agencies downgrades (or subsequently upgrades) its rating assigned to the Notes, as set forth below.

If the rating of the Notes from any one or more of the three Rating Agencies is decreased to a rating set forth in any of the immediately following tables, the interest rate on the Notes will increase from the interest rate otherwise payable on the Notes by an amount equal to the sum of the percentages set forth in the following tables opposite those ratings; *provided*, that only the two lowest ratings assigned to the Notes (or deemed assigned, as provided in the rules of interpretation set forth below) will be taken into account for purposes of any interest rate adjustment:

Moody's Rating	Percentage
Baa1[*]	[____]%
Baa2	[____]%
Baa3	[____]%
Ba1	[____]%
Ba2	[____]%
Ba3	[____]%
B1 or below	[____]%

S&P Rating	Percentage
BBB+[*]	[____]%
BBB	[____]%
BBB-	[____]%
BB+	[____]%
BB	[____]%
BB-	[____]%
B+ or below	[____]%

Fitch Rating	Percentage
BBB+[*]	[____]%
BBB	[____]%
BBB-	[____]%
BB+	[____]%
BB	[____]%
BB-	[____]%
B+ or below	[____]%

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[*] *These rating levels will be adjusted up or down as appropriate under the circumstances and will be negotiated on a case by case basis. It is common for the first level in the table to be one or more notches below the original rating as of the date of issuance.*

[*] *These rating levels will be adjusted up or down as appropriate under the circumstances and will be negotiated on a case by case basis. It is common for the first level in the table to be one or more notches below the original rating as of the date of issuance.*

For purposes of making adjustments to the interest rate payable on the Notes, the following rules of interpretation will apply:

(1) if a Rating Agency has ceased to provide a rating of the Notes for any reason, that Rating Agency will be deemed to have rated the Notes at the lowest level contemplated by the table above;

(2) if only one of the three Rating Agencies ceases to provide a rating of the Notes for any reason, the deemed rating of that Rating Agency will be disregarded for purposes of all interest rate adjustments;

(3) if two of the three Rating Agencies cease to provide a rating of the Notes for any reason, the deemed rating of only one of such two Rating Agencies will be disregarded;

(4) if all three Rating Agencies cease to provide a rating of the Notes for any reason, the interest rate on the Notes will increase to, or remain at, as the case may be, [____]% *[the maximum increase]*[*] above the interest rate otherwise payable on the Notes prior to any adjustment;

(5) each interest rate adjustment required by any decrease or increase in a rating by any one Rating Agency will be made independently of (and in addition to) any and all other adjustments; and

(6) in no event will [(A)] the interest rate on the Notes be reduced to below the interest rate otherwise payable on the Notes prior to any adjustment [or (B) the total increase in the interest rate

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[*] *The appropriateness and size of any cap on the amount of rate increase will be negotiated on a case by case basis.*

on the Notes exceed [____]% above the interest rate otherwise payable on the Notes prior to any adjustment.][*]

If at any time the interest rate on the Notes has been adjusted upward and any of the Rating Agencies subsequently increases its rating of the Notes, the interest rate on the Notes will again be adjusted (and decreased, if appropriate) such that the interest rate on the Notes equals the interest rate otherwise payable on the Notes prior to any adjustment plus (if applicable) an amount equal to the sum of the percentages set forth opposite the ratings in the tables above with respect to the two lowest ratings assigned to the Notes (or deemed assigned) at that time, all calculated in accordance with the rules of interpretation set forth above.

Any interest rate increase or decrease described above will take effect from the first day of the interest period during which a rating change occurs requiring an adjustment in the interest rate. If any Rating Agency changes its rating of the Notes more than once during any particular interest period, the last such change to occur will control in the event of a conflict.

***"Fitch*"** means Fitch Inc., a subsidiary of Fimalac, S.A., and its successors.

***"Moody's*"** means Moody's Investors Service, Inc., a subsidiary of Moody's Corporation, and its successors.

***"S&P*"** means Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., and its successors.

***"Rating Agency*"** means each of Moody's, S&P and Fitch.

Rider 3

Limitation on Liens and Priority Debt. The Indenture provides that the Company will not, and will not permit any of its Subsidiaries to, create, assume, incur, guarantee or otherwise become liable for or suffer to exist any Priority Debt, other than Permitted Debt.

"***Priority Debt***" means:

(1) any Indebtedness of the Company or any of its Subsidiaries that is secured by a Lien on any asset of the Company or any of its Subsidiaries;

(2) Attributable Debt with respect to Sale and Leaseback Transactions; and

(3) any Indebtedness as to which a Subsidiary of the Company is the issuer, borrower, guarantor or in any other manner an obligor.

"***Indebtedness***" means, with respect to any Person, without duplication, any indebtedness of such Person, whether or not contingent:

(1) in respect of borrowed money;

(2) evidenced by bonds, notes, debentures, or similar instruments or letters of credit (or reimbursement agreements with respect thereto);

(3) in respect of banker's acceptances, bank guarantees, surety bonds or similar instruments;

(4) representing Capital Lease Obligations or Attributable Debt in respect of a sale and leaseback transaction; or

(5) representing the balance deferred and unpaid of the purchase price of any property or services due more than six months after such property is acquired or such services are completed;

if and to the extent any of the preceding items (other than letters of credit and Attributable Debt) would appear as a liability upon a balance sheet of the specified Person prepared in accordance with generally accepted accounting principles. In addition, the term "Indebtedness" includes all of the following items, whether or not any such items would appear as a liability on a balance sheet of the specified Person prepared is accordance with generally accepted accounting principles:

(1) all Indebtedness of others secured by a Lien on any asset of the specified Person (whether or not such Indebtedness is assumed by the specified Person);

(2) to the extent not otherwise included, any guarantee by the specified Person of Indebtedness of any other Person; and

(3) preferred stock or other equity interests providing for mandatory redemption or sinking fund or similar payments issued by any Subsidiary of the specified Person.

"Permitted Debt" means:

(1) Priority Debt having an aggregate principal amount (or deemed amount, in the case of Attributable Debt) not to exceed, as of any date of incurrence of Priority Debt pursuant to this clause

(1) and after giving effect to such incurrence and the application of the proceeds therefrom, taken together with the aggregate principal amount of Refinancing Indebtedness incurred to extend, renew, refinance or replace any Priority Debt incurred pursuant to this clause (1), [10-15]% of Consolidated Net Tangible Assets as of such date of incurrence;

[(2) Indebtedness of any Person that (A) is acquired by the Company or any of its Subsidiaries after the date of the Indenture, (B) is merged or amalgamated with or into the Company or any of its Subsidiaries after the date of the Indenture, or (C) becomes consolidated in the financial statements of the Company or any of its Subsidiaries after the date of the Indenture in accordance with generally accepted accounting principles; *provided, however,* that, in each case contemplated by this clause (2), such Indebtedness was not incurred in contemplation of such acquisition, merger, amalgamation or consolidation and is only an obligation of, and is only secured by Liens on the capital stock and assets of, the Person (and Subsidiaries of the Person) acquired by, or merged or amalgamated with or into, or consolidated in the financial statements of, the Company or any of its Subsidiaries;]

[(3) Indebtedness of the Company or any of its Subsidiaries incurred to finance (whether prior to or within 180 days after) the acquisition, construction or improvement of assets (whether through the direct purchase of assets or through the purchase of the capital stock of any Person owning such assets or through an acquisition of any such Person by merger); *provided, however,* that such Indebtedness is only secured by Liens on the capital stock and assets acquired, constructed or improved in such financing;]

(4) Indebtedness of the Company or any of its Subsidiaries existing on the date of the Indenture;

(5) any Indebtedness ("***Refinancing Indebtedness***") incurred to extend, renew, refinance or replace, in whole or in part,

any Indebtedness ("***Refinanced Indebtedness***") referred to in clauses (1) through (4) above or this clause (5) if (A) the principal amount (or deemed amount, in the case of Attributable Debt) of the Refinancing Indebtedness does not exceed the principal amount (or deemed amount, in the case of Attributable Debt) of the Refinanced Indebtedness (plus all premiums and other costs incurred in connection with the extension, renewal, refinancing or replacement thereof) at the time of such extension, renewal, refinancing or replacement and (B) the Refinancing Indebtedness is only an obligation of some or all of the Person(s) who were obligors on the Refinanced Indebtedness and is only secured by Liens on some or all of the assets that secured the Refinanced Indebtedness;

(6) intercompany Indebtedness of the Company or any of its Subsidiaries to the Company or any of its Subsidiaries;

(7) Indebtedness of any of the Company's Subsidiaries in the form of a guarantee of the Notes;

[(8) Indebtedness secured by Liens on accounts receivable and/or inventory and the products and proceeds thereof;] and

(9) [other specific carve-outs to be agreed].[*]

"Attributable Debt" in respect of a sale and leaseback transaction means, at any time of determination, the present value at that time of the obligation of the lessee for net rental payments during the remaining term of the lease included in such sale and leaseback transaction including any period for which such lease has been extended or may, at the option of the lessor, be

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[*] *The marketplace has produced a variety of carve-outs to the various flavors of liens covenants in existence today. Some of these carve-outs are suggested here. In any particular transaction, the carve-outs should be tailored to properly balance the business needs of the issuer with the concerns of bond investors. We recognize that this model form is only a starting place and that some degree of tailoring will be appropriate in most applications.*

extended. Such present value will be calculated using a discount rate equal to the rate of interest implicit in such transaction, determined in accordance with generally accepted accounting principles; *provided, however*, that if such sale and leaseback transaction results in a Capital Lease Obligation, the amount of Indebtedness represented thereby will be determined in accordance with the definition of "Capital Lease Obligation."

"Capital Lease Obligation" means, at any time of determination, the amount of the liability in respect of a capital lease that would at that time be required to be capitalized on a balance sheet prepared in accordance with generally accepted accounting principles.

"Consolidated Net Tangible Assets" of any Person as of any date means the total assets of such Person and its Subsidiaries as of the most recent fiscal quarter end for which a consolidated balance sheet of such Person and its Subsidiaries is available, *minus* all [current] liabilities of such Person and its Subsidiaries reflected on such balance sheet and *minus* total goodwill and other intangible assets of such Person and its Subsidiaries reflected on such balance sheet, all calculated on a consolidated basis in accordance with generally accepted accounting principles.

"Lien" means any mortgage, lien, pledge, charge, security interest or other encumbrance of any kind, whether or not filed, recorded or otherwise perfected under applicable law, including any conditional sale or other title retention agreement, any lease in the nature thereof, any option or other agreement to sell or give a security interest in and any filing of or agreement to give any financing statement under the Uniform Commercial Code (or equivalent statute) of any jurisdiction.

<u>Rider 4</u>

Reports. The Indenture provides that so long as any Notes are outstanding, if the Company is subject to the periodic reporting requirements of the Exchange Act, the Company will file with the SEC and furnish to the Holders of Notes (or cause the trustee to furnish to the Holders of Notes), within the time periods specified in the SEC's rules and regulations:

(1) all quarterly and annual reports on Forms 10-Q and 10-K required to be filed by companies that are subject to the periodic reporting requirements of the Exchange Act; and

(2) all current reports on Form 8-K required to be filed by companies that are subject to the periodic reporting requirements of the Exchange Act.

Each annual report on Form 10-K will include a report on the Company's consolidated financial statements by the Company's certified independent accountants. In addition, the Company will post a copy of each of the reports referred to in clauses (1) and (2) above on its website for public availability within the time periods specified for filing such reports with the SEC in the rules and regulations applicable to such reports.

If, at any time, the Company is no longer subject to the periodic reporting requirements of the Exchange Act for any reason, the Indenture requires that the Company will nevertheless continue to prepare the financial statements and a "Management's Discussion and Analysis of Financial Condition and Results of Operations" substantially similar to that which would have been required to be included in each of the reports specified in clause (1) of the preceding paragraph of this covenant had the Company been subject to such Exchange Act reporting requirements (with all such financial statements prepared in accordance with Regulation S-X promulgated by the SEC and all such annual financial statements including a report thereon from the Company's certified independent accountants) and post copies thereof to its website for

public availability within the time periods that would have been applicable to filing such reports with the SEC in the rules and regulations applicable to such reports if the Company had been required to file those reports with the SEC; *provided*, *however*, that if the Company is no longer subject to the periodic reporting requirements of the Exchange Act, the Company will not be required to comply with Section 302 or Section 404 of the Sarbanes-Oxley Act of 2002, or related Items 307 and 308 of Regulation S-K promulgated by the SEC, or Item 10(e) of Regulation S-K (with respect to any non-GAAP financial measures contained therein).[*]

In addition, the Company will furnish (or cause the trustee to furnish) to Holders of Notes, prospective investors, broker-dealers and securities analysts, upon their request, any information required to be delivered pursuant to Rule 144A(d)(4) under the Securities Act so long as the Notes are not freely transferable under the Securities Act.

<u>Rider 5</u>

Voting by Series. The Indenture provides that no amendment or waiver that requires a consent of Noteholders under the Indenture may be effected without the additional consent of the Holder(s) of a majority in aggregate principal amount of each series of Notes then outstanding having an aggregate principal amount of $100.0 million or more.[*]

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[*] *Other exceptions to the SEC's specific reporting obligations may be negotiated on a case by case basis.*

[*] *In some cases, it may be appropriate for more than one series to vote together as a single class — for example, in a Medium Term Note program involving numerous small issuances of notes having differing terms, or where two series of notes share maturities and other material terms.*

Annex B

www.creditroundtable.org

Top 10 Questions to Ask for Each New Investment Grade Offering

The initial question for every offering should be: Is the protective language the same as the language in the Covenant White Paper? If not, how is it different?

Change of Control

1. What events constitute a Change of Control?
The definition should pick up: (1) the acquisition of a majority of the issuer's voting stock, (2) a sale of substantially all the issuer's assets, (3) a merger with another company where the issuer's stockholders don't own a majority of the stock after the deal is closed, (4) continuing board directors, and (5) a plan of liquidation. Prospective purchasers should also make specific inquiry as to the existence of any carveouts/exceptions to the listed change of control triggers and if so, the business rationale/justification for including them.

2. Is rating agency testimony required to connect the ratings downgrade and the Change of Control?
Does the covenant require that the rating agencies state that the reason for the downgrade was the change of control? Rating agencies may not be willing to make this connection. The White Paper's model provision only requires that the downgrading occurs during a time period that straddles the Change of Control transaction.

3. What happens if a rating agency ceases to rate the bonds?
If the issuer has the right to replace a rating agency when coverage by the original agency is dropped, bondholders may be at risk because a new agency might not apply the same criteria as the original agency. The White Paper's model provision treats bonds as being "below investment grade" unless two out of the three specified agencies maintain an investment grade rating on the bonds.

Step-Up Coupon

4. Is the step-up provision subject to a cap? Is there a fall-away provision if the bonds are upgraded beyond a specified level?
The value of the step-up feature is diminished if it is subject to a cap on the amount of the rate increase or if the protection goes away once the issuer achieves a certain rating. Subsequent downgrades can always occur after an upgrade.

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5. What happens if a rating agency ceases to rate the bonds?
The White Paper's model provision allows an issuer with ratings from three major rating agencies to lose coverage from one of the three agencies without consequence. Subsequent withdrawals of ratings are treated as a reduction in rating that triggers a coupon step-up.

Limitation on Liens and Priority Debt

6. Does the covenant only apply to "Restricted Subsidiaries" or "Principal Properties"?
To the extent the covenant only applies to Restricted Subsidiaries, Principal Properties or some other defined subset of entities or properties, you will want to know which entities/properties are actually covered by the covenant. Determining the scope of these definitions is important in order to determine what percentage of the issuer's EBITDA and valuable assets is protected from claims of holders of priority debt. The disclosure will not always give you the answers to these questions. Don't be afraid to ask for this important information.

7. Are there limitations on subsidiary debt or guarantees?
The White Paper's "Limitation on Liens and Priority Debt" restricts the incurrence of structurally senior debt by subsidiaries. If there are no such restrictions, the bonds are subject to being "primed" in a future financing. Many recent LBOs have used subsidiary guarantees of the LBO debt to "prime" the existing investment grade bonds.

8. Is there an "equal and ratable" clause that gives the issuer the ability to incur unlimited secured debt?
Most traditional "Liens" covenants permit the issuer to incur unlimited secured debt so long as the bonds are secured equally and ratably with the new debt. These "equal and ratable" provisions have been used to incur substantial additional debt in a transaction (for example, to finance an LBO) that can cause your bonds to lose value. The White Paper's model provision does not permit unlimited additional secured debt — it has no "equal and ratable" clause and is therefore more restrictive than the traditional approach.

Reporting Obligations

9. Is there an unconditional obligation to provide financials and MD&A, or is the obligation tied to '34 Act reporting obligations that could fall away in an LBO?
Some investment grade bond indentures do not contain an unconditional obligation to provide financial information. If the issuer eventually goes private, or the issuer becomes a subsidiary of another corporation, the obligation to file financial information with the SEC goes away. This means that bond buyers could lose access to issuer-level financial data in the future, which could adversely affect the trading price of your bonds.

Voting

10. Are indenture amendments subject to a bondholder vote on a series-by-series basis or do all series vote together to approve indenture amendments? If voting is by indenture, what other bonds are (or may in the future be) issued under this indenture?
Some investment grade indentures permit amendments or waivers to be approved by the holders of a majority in aggregate principal amount of the notes then outstanding under that indenture, regardless of how many series of notes may at the time be outstanding. More protection exists for bondholders if each series of bonds must separately approve all covenant changes applicable to that series, even if the covenants benefit multiple series of bonds. Different series with differing terms may have very different economic incentives when it comes to approving covenant changes.