Article Title: ARCHIVE | Criteria | Corporates | General: Change-Of-Control Covenants' Wording Can Be Crucial Data: In the current takeover environment, investors are demanding protection in the form of a change-of-control put--when they can get it. Standard & Poor's Ratings Services' ratings on individual debt issues with such covenants will reflect the protection for that issue. When a takeover is announced and the target company's corporate credit rating is downgraded as a consequence, a specific bond with put protection could retain the rating that prevailed before the announcement, while nonprotected issues would be downgraded. Efficacy Of Covenants Varies By Scenario The benefit of these covenants pertains only to the extent that takeover risk is a rating factor. Remember that ratings, in general, do not incorporate takeover/event risk, so covenants would not benefit the rating prior to the emergence of a takeover threat (see Acquisition Risk And Its Effect On Ratings, published Sept. 11, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.) We would need to assess the effectiveness of the covenant(s) in relation to the specific fact pattern and/or scenarios of concern that were incorporated in the corporate rating. (For example, such a covenant would not address the possibility of defensive actions that would thwart the takeover, but leave the company a weaker credit.) Also, most of these covenants require, in addition to any change of control, a rating agency response. The rating action thus affirms the negative impact on the affected bond. While the rationale for requiring a change in ratings is quite apparent, the details of a given covenant can limit or undermine the protection, sometimes in unintended ways. We have never acquiesced to being the de facto arbiter of a covenant's application, nor do we take sides in potential questions over the protective coverage. We do, however, strive to act responsibly, and not in a manner that could void the covenants, if possible. We operate with the general premise that covenants are intended to actually protect the bondholders. Problems with the specific language as it relates to ratings presumably arise from poor drafting or ignorance of how rating agencies operate, rather than deliberate attempts to undermine the covenant's efficacy. The Devil Is In The Details As discussed individually below, complications can arise because of specific language relating to requirements for: A rating action linked directly to the change of control; A rating action within a specified timeframe; A rating action on the issue (as opposed to the issuer); and/or An action by more than one rating agency. Linkage of the rating action to the change of control Rationale. Some covenants specify that the downgrade should result from the change in control, and some go further by specifying that the change in control is the exclusive reason for the downgrade. Thus, the protective features apply only in respect to the change of control; other factors that caused or contributed to a downgrade represent normal credit risk that legitimately should be borne by the investors, and should not lead to a special remedy. The underlying basis for the rating downgrade--as a direct consequence of the change in control--clarifies whether the investors should be entitled to protection. Problems. Ratings take into account anything and everything that affects the credit profile of the company. Sometimes there is one risk--and one risk only--that leads to a rating action. But more often, it is some combination of risks that pertain. (There might be a single dominant factor, or several factors, each of which is immaterial in its own right.) Accordingly, it would be unlikely for us to base a downgrade entirely on change in control. The protection of covenants that excluded contributing factors would regularly be undermined. However, any linkage would be open to interpretation and contention/litigation. Even if the covenant language were not explicit about excluding contributing factors, an argument could be made that the downgrade was not the result of the change in control, but of multiple factors. Consider also the following example: Following a takeover announcement, we downgraded our corporate credit rating on the issuer to speculative grade. We explained that even if the deal collapsed, we expected either that another deal would emerge, or that the company would be pressured into changing its financial policy to enhance shareholder returns. (This example is not hypothetical; it happened with Harrah's Entertainment Inc. and its subsidiary Harrah's Operating Co. Inc. On Oct. 2, 2006.) The question is whether this downgrade resulted from a change in control: A judge would have to decide. Given the dubious protection if causality between the change of control and our downgrade is needed, most covenants rely on the proximity in time of the change of control and the rating action. Timing of the rating action Rationale. The linkage of the change of control to negative credit consequences should not be open-ended; over time, there might factors other than the change of control that contribute to a weaker credit. In addition, the company should not have a put hanging over it for an extended period.

(An example of what companies seek to avoid is the case of GUS PLC, where holders tried to invoke a put provision in 2006 following a de-merger, despite the absence of negative credit consequences.) Most frequently, the 'downgrade window' has been restricted to 90 or 180 days from the takeover announcement date, or from completion date. Problems. One problem that has cropped up is the covenant with wording alluding to a downgrade following the change of control. In this case, a downgrade in anticipation of that change would not conform to the protected scenario. Because a downgrade rarely precedes an announcement of a takeover, a change-of-control covenant would offer better protection if the rating timeframe commenced with the announcement of a takeover bid. Another problem could result from requiring a downgrade within too limited a time. Often we place a rating on CreditWatch for review until the picture is clarified in all key aspects; this process might exceed the timeframe incorporated in the covenant. Especially where the timeframe starts from time of announcement, there could be a protracted period of uncertainty if there is a bidding war or the company contests the offer. We cannot change the rating process merely because our practices may not trigger a problematic covenant specification. To be effective, the covenant needs be appropriately drafted. With a time limit, the protection is greatest if it start from the time a transaction is known or announced, and extends as long as the credit remains under formal review. Rating action on the debt issue Rationale. The change of control should affect the specific instrument that incorporates the put protection; a downgrade that affects only other securities should not allow the holders of this security to get paid. (In fact, it is not often that the corporate credit rating downgrade following a takeover would allow an individual unsecured issue to remain investment grade. However, it is conceivable, as explained below. Also, under Standard & Poor's proposed new definition of issue ratings--which calls for notching up all issues that have significantly better-than-average recovery prospects--such a pattern will be more common.) Problems. If the covenant requires the issue to be downgraded, it poses a true paradox with respect to rating practice: If we were to downgrade the issue, the covenant is triggered, so protection pertains: Therefore, the downgrade is unwarranted. Conversely, if we maintain the rating to reflect the protection of the covenant, there is no trigger and no protection: Therefore, the maintenance of the rating is not deserved! Confronted with this paradox, we will downgrade the issue. The downgrade will be the minimum sufficient to trigger the covenant protection, rather than merely following in step with our action on the corporate rating. For example: Company XYZ and its senior unsecured bonds are rated 'A'; XYZ issues a bond with a put triggered by change-of-control plus downgrade of the bond to speculative grade, also rated 'A' prior to emergence of takeover risk. Following an LBO transaction, the corporate credit rating on XYZ is lowered to 'B' and its unprotected bonds are also downgraded to 'B'; the XYZ bond with a put is downgraded to 'BB+'. This action suffices to avoid depriving the bond investors of the purported protection, while, by not downgrading to 'B', we recognize the protection that differentiates this bond from the company's other, unprotected issues. Another problematic scenario involves bonds notched down from the corporate rating. Imagine a marginal investment-grade company that issues secured debt, prior to any takeover activity. As part of ongoing surveillance, the 'protected' unsecured bond is lowered one notch, from 'BBB-' to 'BB+', because of its junior status. There will never be a downgrade to speculative grade for takeover reasons, because it already will be rated speculative grade, and the protection will not be effective. Few covenant wordings we have seen address this scenario, but some do. Unlike the previous situation, the corporate credit rating may go to high speculative grade while the protected bond could remain investment grade because of strong recovery prospects. The bond-rating-driven protection will not apply, although one might argue that indeed it does not deserve protection, given its rating status. Actions by more than one rating agency Rationale. There is a perceived risk to the company or its acquirers that a rating agency may take an action that is rash or arbitrary. By linking the protection to two or more agencies taking similar rating actions, the risk of such an ill-founded action is mitigated. The validity of one agency's conclusion is confirmed by the other's similar position. Problems. The question here is how Standard & Poor's (or another agency) can assess the likelihood of the protection working without knowing--or speculating about--what the other agency will do. For example: in a case that ties the put to two agencies lowering the corporate rating, if we lowered the corporate rating to speculative grade, but maintained the rating on the protected bond, our rating would be incorrect if the other agency did not follow suit by also lowering its corporate rating. Conversely, if we downgraded the bond and the other agency wound up lowering its corporate rating, our issue rating would also turn out wrong, as the put allowed investors to get paid. There are probably cases where we could feel confident about anticipating another agency's actions. But we equally could be faced with a situation of uncertainty (especially when there may be complications such as those described in this article). While there is always the option of placing the specific issue on CreditWatch, that might not prevent a situation where each agency is waiting for the other to act or telescope their intended action.