A Key Pitfall Of Restricted Subsidiaries In Loan Agreements

By **David Ebroon and Jared Zajac** (April 16, 2024)

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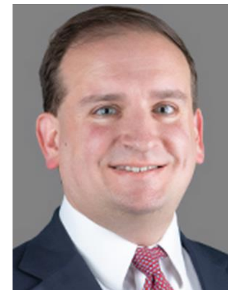
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A sophisticated company negotiating loan terms with its lender typically apportions obligations and restrictions among various categories in such company's corporate family — most commonly referred to as loan parties, non-loan party restricted subsidiaries and unrestricted subsidiaries.

Over the past several years, the most aggressive liability management transactions have utilized unrestricted subsidiaries as the cornerstone for such transactions. As sponsors and borrowers, however, expand their playbooks and devise more creative transactions, non-loan party restricted subsidiaries have garnered more attention.

Indeed, the recent At Home Group Inc. transaction used a non-loan party restricted subsidiary and put a spotlight on one such risk: the so-called double dip. But that is not the only potential hazard for lenders.

This article highlights the treatment afforded to the earnings before interest, taxes, depreciation, and amortization, or EBITDA, of non-loan party restricted subsidiaries, and the adverse impact such treatment may have on the position of lenders.

Loan documents generally refer to loan parties as company entities that have a direct obligation to repay a given loan — or, alternatively, guaranty such loan — and such entities typically pledge collateral to secure the underlying debt. Lenders routinely bargain for covenants and other terms to restrict the activities of loan parties, e.g., incurrence of indebtedness, asset sales, transactions with affiliates, etc.

A second customary category of entities in loan agreements is unrestricted subsidiaries, which do not provide any credit support or otherwise guaranty the underlying loan and, as the name suggests, are not bound by the covenants and other restrictions of the loan agreement.

A third category is non-loan party restricted subsidiaries — which are entities in the borrower's corporate family that do not have a primary obligation to repay the loan, or provide a guaranty, nor do such entities pledge collateral to secure the underlying debt. But unlike unrestricted subsidiaries, non-loan party restricted subsidiaries are bound by the covenants and other restrictions of the loan agreement.

As such, the failure of a non-loan party restricted subsidiary to comply with the terms of the loan agreement — by, for example, incurring indebtedness above a specified amount — would trigger a default under such loan agreement.

Over the last few years, lenders have increasingly focused on the risks posed by unrestricted subsidiaries. The lenders to Envision Healthcare Corp., for example, thought they had sufficient protections around preserving the value of the borrower's coveted ambulatory unit, only to witness that business unit become an unrestricted subsidiary.

Similarly, the lenders to Instant Brands witnessed valuable assets transferred to an unrestricted subsidiary, which then raised structurally senior debt secured by those lost assets.

Much brainpower has been exuded, and ink has been spilled, to protect against threats posed by unrestricted subsidiaries, and rightly so. But lenders should not lose sight of a key hazard posed by non-loan party restricted subsidiaries: the application of EBITDA.

Lenders making cash flow loans, where credit risk is underwritten on the basis of the company's operations and the expected cash flows from such operations, rely on EBITDA as the primary metric to gauge the financial health and earning power of a company.

Covenants and other financial standards established by lenders are typically keyed off of EBITDA. A financial covenant included in many loan agreements, for example, is the leverage covenant — which essentially provides that total indebtedness will not exceed a specified multiple of EBITDA, e.g., the ratio of total indebtedness to EBITDA cannot exceed X:00 to 1.00.

Given that non-loan party restricted subsidiaries (1) do not have any obligation to repay the loan, either as a primary obligor or as a guarantor, and (2) do not pledge any collateral to secure the loan, one might expect that the earning power of such non-loan party restricted subsidiaries would be excluded for purposes of calculating EBITDA under the loan agreement.

But the opposite, in most cases, is in fact the case; that is, the earning power of such non-loan party restricted subsidiaries is included in the EBITDA calculation.

The reasons for this are primarily historical. Over time, the lending market has accepted the contention that the cash flow generated by the company's entire "restricted" business enterprise — that is, entities in the company's corporate family that are subject to the terms of the loan agreement — should be considered as the basis for repayment of the debt.

But this approach has an apparent potential to impair lenders if a company group's aggregate EBITDA is skewed toward non-loan party restricted subsidiaries.

Consider the Following Sample Facts

The lender has determined, based on the company's static debt position, that the company must generate not less than $95 million of EBITDA in order to comfortably satisfy its obligations under the loan agreement.

As such, the lender establishes a covenant requiring that the company's consolidated EBITDA not fall below $100 million.

Scenario 1

- Loan parties collectively generate $95 million of EBITDA.
- Non-loan party restricted subsidiaries collectively generate $6 million of EBITDA.
- Based on customary loan terms, the EBITDA of both the loan parties and the non-loan party restricted subsidiaries are assessed for purposes of the EBITDA covenant

— meaning that $101 million of EBITDA is counted for covenant purposes — and, as such, there is no default under the credit agreement.

Is the Lender at Risk?

No, because the loan parties are primary obligors, or guarantors, of the loan, and they have pledged collateral to secure the loan. As such, $95 million of EBITDA cash generation, sometimes referred to as creditworthiness, and underlying pledged collateral are available to the lender to support repayment of the loan.

Scenario 2

- Loan parties collectively generate $6 million of EBITDA.
- Non-loan Party Restricted Subsidiaries collectively generate $95 million of EBITDA.
- As in Scenario 1, the EBITDA of both the loan parties and the non-loan party restricted subsidiaries are assessed for purposes of the EBITDA covenant — meaning that $101 million of EBITDA is counted for covenant purposes, and, again, there is no default under the credit agreement.

Is the Lender at Risk?

Yes, because the lender has access to only $6 million of the loan parties' EBITDA cash generation and underlying pledged collateral to support repayment of the loan. Remember, the EBITDA of the non-loan party restricted subsidiaries counts for covenant purposes, but such non-loan party restricted subsidiaries have no obligation to repay the loan, and have not pledged any collateral to secure the loan.

In both Scenario 1 and Scenario 2 above, an identical $101 million of EBITDA is generated by the company's corporate family — but, in a downside scenario, the results for the lender would be dramatically different. Accordingly, lenders would be well-served to consider the role non-loan party restricted subsidiaries play in the company's operations and revenue and profit generation.

The straightforward antidote to the risk identified above is to limit, or cap, the EBITDA generated by non-loan party restricted subsidiaries that count for purposes of calculating consolidated EBITDA for covenant and other purposes under the loan agreement. Unfortunately, the market has largely rebuffed this measure.

Lenders may consider an alternative, more nuanced — albeit less effective — approach by adding additional covenants and/or incorporating more restrictions on high-EBITDA generating non-loan party restricted subsidiaries.

Separate from the considerations set forth above, borrowers often negotiate the ability to invest assets among its corporate family — which right is typically subject to compliance with a pro forma leverage ratio.

As non-loan party restricted subsidiaries customarily contribute to EBITDA, an investment of assets among loan parties and non-loan party restricted subsidiaries is a leverage neutral event. As such, setting this leverage ratio too high could allow a borrower to remove assets from its lender's collateral pool — by taking assets from loan parties and investing them in

non-loan party restricted subsidiaries — during a time of distress.

The threats posed by non-loan party restricted subsidiaries are more subtle than those posed by unrestricted subsidiaries, but in many cases they are equally serious. Most of these risks, however, can be mitigated by a thoughtful understanding of how non-loan party restricted subsidiaries operate in the loan agreement context, and appropriately addressing these risks when underwriting loans and drafting loan agreements.

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