Hybrid Horizons: Covenants in Today’s Hybrid Capital Instruments

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Overview

Hybrid Capital instruments occupy a middle ground between debt and equity. While often legally structured as equity, Hybrid Capital instruments typically contain debt-like affirmative and negative covenants that balance the issuer’s need for flexibility and harmony with senior capital with the investor’s desire for downside protection, priority of payments and preservation of value. While covenant packages vary from deal to deal more so than in traditional secured debt agreements, certain trends have emerged for Hybrid Capital, especially in transactions involving larger issuers with more sophisticated debt arrangements and large dollar Hybrid Capital tranches. This article sets out a high-level summary of certain key covenants to expect in Hybrid Capital transactions.

Seniority of the Hybrid Capital Instrument

A central covenant in Hybrid Capital instruments is the restriction on the issuer’s issuance of senior and/or *pari passu* capital. Issuers often negotiate for the ability to issue additional *pari passu* equity, but typically subject to negotiated total leverage ratios (which include the Hybrid Capital liquidation preference in the calculation) or dollar caps, as well as rights of first offer in favor of the existing Hybrid Capital investors. Hybrid Capital is structurally subordinate to equity and creditors of the issuer’s subsidiaries because, unlike debt instruments that can benefit from guarantees up and down a capital structure, Hybrid Capital is generally not guaranteed by operating subsidiaries. As a result, credit facility covenants relating to capital that is junior to the senior credit may not be sufficient to protect the interests of a Hybrid Capital investor. The risks to Hybrid Capital instruments posed by equity and other capital issuances by subsidiaries are often addressed through anti-layering covenants, which will be the subject of an upcoming article in our Hybrid Horizons series.

Debt Incurrence Restrictions

Another key covenant in Hybrid Capital instruments is a restriction on the incurrence of indebtedness by the issuer's subsidiaries. The restriction is typically based on a leverage ratio of the issuer's consolidated group to be measured at the time of a proposed future debt incurrence, often set at, or related to, the debt leverage ratio at closing. Exceptions generally include borrowings under the revolving line of credit in place at closing and certain refinancings. Issuers often seek exceptions for categories of "Indebtedness" that are exempted from the senior credit debt incurrence restriction (general baskets and seller paper issued in M&A transactions, for example). However, given the different dynamics for Hybrid Capital investors as compared to secured lenders discussed in the Seniority section above, these exceptions are negotiated and not necessarily mirrored in the Hybrid Capital documentation.

Restricted Payments

In order to protect Hybrid Capital's seniority, issuers are restricted in the types and/or amounts of payments that can be made by the issuer and its subsidiaries to equity owners, affiliates and other junior stakeholders. The restricted payment covenant is often drawn from the restricted payment covenant in the primary credit agreement of the issuer's consolidated group. Like debt incurrence, however, Hybrid Capital investors will often try to draft the restricted payments covenant more narrowly than the senior credit covenant.

Affirmative and Negative Covenants

In addition to the central covenants, Hybrid Capital documents typically contain a package of less critical covenants, often drawn from the primary credit agreement of the issuer's consolidated group. Information rights or reporting covenants often track those set out in the credit agreement but can also include board observer or even board designation rights. The scope of other covenants varies from deal to deal and, depending on what sector of the market is at play (e.g., large cap, middle market, etc.), can include essentially all of the affirmative and negative covenants contained in the issuer's credit agreement, some of the important other "value-protecting" covenants such as restrictions on investments, asset dispositions and capital expenditures or, in some instances, less than that.

Issuers (and their lender groups) are often successful in insisting that the Hybrid Capital covenant restrictions reflect a cushion over the applicable limitations set out in the issuer's credit documents. Also, inclusion of financial maintenance covenants in Hybrid Capital documentation is extremely rare, both as a matter of market convention and likely because of the limitations on enforcement rights implicit in Hybrid Capital, which will be the subject of another article in our Hybrid Horizons series.

Conclusion

While there remains a great deal of variation in the market, Hybrid Capital instruments typically contain affirmative and negative covenants that are not dissimilar to those contained in credit agreements. Given the important distinctions between secured debt and Hybrid Capital, however, including Hybrid Capital's structural subordination to both creditors and equity issued by an issuer's subsidiaries, Hybrid Capital investors should carefully consider the covenant packages that they obtain so that they match their expectations around seniority, issuer leverage and the protection of assets underlying their investment.

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